Internal Revenue

bulletin

Bulletin No. 2002–13
April 1, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

SPECIAL ANNOUNCEMENT

Announcement 2002–37, page 703.
Methods of accounting. This announcement discusses some of the most significant and prevalent issues raised in comments received in connection with Notice 98–31 (1998–1 C.B. 1165), which proposed procedures for Service-imposed accounting method changes and the resolution of accounting method issues on a nonaccounting-method-change basis.

INCOME TAX

Rev. Rul. 2002–15, page 668.
Fringe benefits aircraft valuation formula. The Standard Industry Fare Level (SIFL) cents-per-mile rates and terminal charges in effect for the first half of 2002 are set forth for purposes of determining the value of noncommercial flights on employer-provided aircraft under section 1.61–21(g) of the regulations.

T.D. 8984, page 668.
REG–102740–02, page 701.
Temporary, final, and proposed regulations under sections 337(d) and 1502 of the Code permit certain losses recognized on sales of subsidiary stock by members of a consolidated group. The regulations apply to corporations filing consolidated returns, both during and after the period of affiliation, and also affect purchasers of the stock of members of a consolidated group. A public hearing on the proposed regulations is scheduled for July 17, 2002.

Announcement 2002–34, page 702.
Extension of time to file Forms 1042-S. The Service announces an extension of time to file 2001 Form(s) 1042-S from March 15, 2002, to May 15, 2002.

EMPLOYEE PLANS

Announcement 2002–36, page 703.
Employee plans determinations letters; future of program. The Service extends the time, as stated in Announcement 2001–83 (2001–35 I.R.B. 205), for the submission of public comments on the future of the EP determination letter program from March 31, 2002, to July 1, 2002.

ADMINISTRATIVE

Rev. Proc. 2002–17, page 676.
Inventories; replacement cost; automobile dealers. A safe harbor method of accounting (the "replacement cost method") is provided for automobile dealers to approximate the cost of their vehicle parts inventory using the replacement cost of the parts. Procedures are also provided for automobile dealers to obtain the automatic consent of the Commissioner to change to the replacement cost method. Rev. Proc. 2002–9 modified and amplified.

Rev. Proc. 2002–18, page 678.
Changes in method of accounting; examinations. Procedures are provided under section 446 of the Code for changes in method of accounting imposed by the Service. Procedures are also provided for resolving accounting method issues on a nonaccounting-method basis.

Rev. Proc. 2002–19, page 696.
Changes in method of accounting; prior consent; automatic consent. Rev. Procs. 97–27 and 2002–9 are modified to (1) allow certain taxpayers under examination or before appeals or a federal court to change their method of accounting prospectively without audit protection, (2) reduce from 4 years to 1 year the adjustment period for prospective changes resulting in a net negative adjustment under section 481(a) of the Code, and (3) make certain other conforming changes. Rev. Procs. 97–27 and 2002–9 modified and amplified.

Finding Lists begin on page ii.
Index for January through March begins on page v.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Section 61.—Gross Income Defined

26 CFR 1.61–21: Taxation of fringe benefits.

Rev. Rul. 2002–15

Fringe benefits aircraft valuation formula. For purposes of section 1.61–21(g) of the Income Tax Regulations, relating to the rule for valuing noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL) cents-per-mile rates and terminal charge in effect for the first half of 2002 are set forth.

For purposes of the taxation of fringe benefits under section 61 of the Internal Revenue Code, section 1.61–21(g) of the Income Tax Regulations provides a rule for valuing noncommercial flights on employer-provided aircraft. Section 1.61–21(g)(5) provides an aircraft valuation formula to determine the value of such flights. The value of a flight is determined under the base aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL) by multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple provided in section 1.61–21(g)(7) and then adding the applicable terminal charge. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are reviewed semi-annually.

The following chart sets forth the terminal charges and SIFL mileage rates:

Period During Which the Flight Is Taken	*Terminal Charge*	*SIFL Mileage Rates*
1/1/02 — 6/30/02	$37.12	Up to 500 miles = $.2031 per mile 501–1500 miles = $.1548 per mile Over 1500 miles = $.1489 per mile

DRAFTING INFORMATION

The principal author of this revenue ruling is Kathleen Edmondson of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Ms. Edmondson at (202) 622–6040 (not a toll-free call).

Section 337.—Nonrecognition for Property Distributed to Parent in Complete Liquidation of Subsidiary

26 CFR 1.337(d)–2: Loss limitation window period.

T.D. 8984

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Loss Limitation Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations under sections 337(d) and 1502. These regulations permit certain losses recognized on sales of subsidiary stock by members of a consolidated group. These regulations apply to corporations filing consolidated returns, both during and after the period of affiliation, and also affect purchasers of the stock of members of a consolidated group. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject on page 701 of this issue of the Bulletin.

DATES: *Effective Date*: These regulations are effective March 7, 2002.

Applicability Date: For dates of applicability, see §§ 1.337(d)–2T(g), 1.1502–20T(i) and 1.1502–32T(b)(4)(v).

FOR FURTHER INFORMATION CONTACT: Sean P. Duffley (202) 622–7530 or Lola L. Johnson (202) 622–7550 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1774. Responses to this collection of information are voluntary.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

For further information concerning this collection of information, and where to submit comments on the collection of

information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking (REG–102740–02) on page 701 of this Bulletin.

Books or records relating to the collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 337(d) of the Internal Revenue Code, enacted in 1986, directs the Secretary to prescribe regulations to ensure that the purposes of *General Utilities* repeal, which generally requires a corporation to recognize gain or loss on a disposition of any asset, may not be circumvented through the use of the consolidated return regulations. Pursuant to that directive, in 1990, the IRS and Treasury promulgated § 1.337(d)–2. Section 1.337(d)–2 generally disallows any loss recognized by a member of a consolidated group on the disposition of subsidiary stock, except to the extent the consolidated group disposes of its entire equity interest in a subsidiary to persons not related to any member of the consolidated group within the meaning of section 267(b) or section 707(b)(1) (applying the language "10 percent" instead of "50 percent") and can establish that such loss is not attributable to the recognition of built-in gain. Section 1.337(d)–2, however, only applies with respect to dispositions and deconsolidations that occur on or after November 19, 1990, and that are not subject to § 1.1502–20.

Section 1.1502–20, which applies to all dispositions and deconsolidations of subsidiary stock that occur on or after February 1, 1991, disallows certain losses recognized by a member of a consolidated group on the disposition of subsidiary stock. The rule disallows losses to the extent of the sum of "extraordinary gain dispositions," "positive investment adjustments," and "duplicated loss." The rule is designed not only to implement *General Utilities* repeal, but also to further single entity principles by preventing the allowance of stock losses that are reflected in a subsidiary's assets or loss carryovers.

In *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), the United States Court of Appeals for the Federal Circuit held that the duplicated loss component of § 1.1502–20 was an invalid exercise of regulatory authority. As stated in Notice 2002–11 (2002–7 I.R.B. 526), the IRS has decided that the interests of sound tax administration will not be served by continuing to litigate the validity of the loss duplication factor of § 1.1502–20. Moreover, because of the interrelationship in the operation of all of the loss disallowance factors, the IRS and Treasury have decided that new rules governing loss disallowance on sales of stock of a member of a consolidated group should be implemented.

Explanation of Provisions

This Treasury decision adds §§ 1.337(d)–2T, 1.1502–20T(i), and 1.1502–32T(b)(4)(v), as described below.

For dispositions and deconsolidations of subsidiary stock on or after March 7, 2002, unless the disposition or deconsolidation was effected pursuant to a binding written contract entered into before such date that was in continuous effect until the disposition or deconsolidation, this Treasury decision provides that § 1.337(d)–2T, and not § 1.1502–20, governs the amount of loss allowable on such sales, or the amount of basis reduction required on such deconsolidations, of subsidiary stock. In substantial part, § 1.337(d)–2T restates the current § 1.337(d)–2, with certain modifications. As described above, as currently in effect, § 1.337(d)–2 permits recognition of loss only where a consolidated group disposes of its entire equity interest in a member of the group to persons not related to any member of the consolidated group within the meaning of section 267(b) or section 707(b)(1) (applying the language "10 percent" instead of "50 percent"). Section 1.337(d)–2T eliminates those restrictions.

For dispositions and deconsolidations of subsidiary stock before March 7, 2002, and dispositions and deconsolidations of subsidiary stock on or after March 7, 2002, that were effected pursuant to a binding written contract entered into before such date that was in continuous effect until the disposition or deconsolidation, this Treasury decision adds § 1.1502–20T(i). Section 1.1502–20T(i) permits consolidated groups to calculate allowable loss on the sale of subsidiary stock by applying § 1.1502–20 in its entirety or, in lieu thereof, by electing to apply one of two alternative regimes. In particular, the group may elect to apply the provisions of § 1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, *i.e.*, calculating disallowed loss by taking into account only extraordinary gain dispositions and positive investment adjustment amounts. Alternatively, the group may elect to apply the provisions of § 1.337(d)–2T. Such election may be made with the original return for the taxable year that includes the later of March 7, 2002, and the date of the disposition or deconsolidation of the stock of the subsidiary. Alternatively, the election may be made with an amended return, provided that the amended return is filed before the date the original return for the taxable year that includes March 7, 2002, is due.

An election described in § 1.1502–20(g) to reattribute losses will be respected only if the requirements of § 1.1502–20(g), including the requirement that the election be filed with the group's income tax return for the year of the disposition, have been or are satisfied. The temporary regulations do not extend the time for filing an election under § 1.1502–20(g). If a group made an election described in § 1.1502–20(g) and elects to determine allowable loss by applying one of the alternative regimes pursuant to § 1.1502–20T(i), the amount of loss treated as reattributed may be reduced. If the group elects to determine allowable loss by applying the provisions of § 1.1502–20 without regard to the duplicated loss factor of the loss disallowance formula, the amount of loss treated as reattributed is equal to the amount of loss originally reattributed, reduced to the extent that it exceeds the greater of (1) the loss disallowance amount determined by taking into account only extraordinary gain dispositions and positive investment adjustments (and not the duplicated loss factor of the loss disallowance formula) and (2) the amount of reattributed losses that the common parent of the selling group absorbed in closed years. If the

group elects to determine allowable loss by applying § 1.337(d)–2T, the amount of loss treated as reattributed is the greater of (1) zero and (2) the amount of reattributed losses that the common parent of the selling group absorbed in closed years. For this purpose, a taxable year is a closed year to the extent the assessment of a deficiency is prevented by any law or rule of law as of the date the election to apply one of the alternative regimes is filed and at all times thereafter.

To the extent that an election under § 1.1502–20T(i) results in a reduction in the amount of losses treated as reattributed, such excess losses will be treated as available for use by the subsidiary or any other group of which the subsidiary is a member, subject to any applicable limitations (*e.g.*, section 382). In order to permit the subsidiary's use of such losses that are subject to an existing section 382 limitation, § 1.1502–20T(i) allows the common parent of the group that disposed of the stock to make certain adjustments to the amount of such a limitation apportioned under § 1.1502–95 or § 1.1502–96.

Section 1.1502–20T(i) requires the common parent of the selling group to notify the subsidiary of the recomputed reattribution amount and any adjustment to the apportionment of a section 382 limitation made in connection with the election to apply one of the alternative regimes. In addition, if the acquirer was a member of a consolidated group at the time of the acquisition, the common parent of the selling group must provide such notification to the common parent of the acquirer at the time of the acquisition. The rules set forth in § 1.1502–20T(i) also confirm that any losses treated as reattributed to the common parent of the selling group will not be available to offset income of the subsidiary or any other group of which such subsidiary is a member.

The IRS and Treasury do not intend for a purchasing consolidated group to be unfairly disadvantaged in the event that the common parent of a selling member elects to apply one of the alternative regimes under § 1.1502–20T(i) and, as a result, the amount of losses treated as reattributed to the common parent of the selling group is decreased and the amount of losses treated as available to the subsidiary is increased. Therefore, this Treasury decision adds § 1.1502–32T(b)(4)(v), which provides that, to the extent that the subsidiary's loss carryovers are increased by reason of an election to apply one of the alternative regimes and such loss carryovers expire, or would have been properly used to offset income, in a closed year, the purchasing group will be deemed to have made an election to treat all of such expired loss carryovers as expiring for all Federal income tax purposes immediately before the subsidiary became a member of the purchasing group. Accordingly, no basis reduction under § 1.1502–32 will result from the expiration of, or failure to use, such losses.

Section 1.1502–32T(b)(4)(v) further provides that, to the extent the subsidiary's loss carryovers are increased by reason of an election to apply one of the alternative regimes and such loss carryovers have not expired, and would not have been properly used to offset income, in a closed year, the purchasing group may make an election under § 1.1502–32(b)(4) to treat all or a portion of such loss carryovers as expiring for all Federal income tax purposes immediately before the subsidiary became a member of the purchasing group. The election must be filed with the purchasing group's return for the taxable year in which the subsidiary receives the notification of the recomputed reattributed loss amount.

For purposes of § 1.1502–32T(b)(4)(v), a taxable year is a closed year to the extent the refund of an overpayment is prevented by any law or rule of law as of the date the group files its original return for the taxable year in which the subsidiary receives the notification of the recomputed reattributed loss amount and at all times thereafter.

Special Analyses

In light of the Federal Circuit's decision in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), these temporary regulations are necessary in order to provide taxpayers with immediate guidance regarding allowable loss and basis reductions in connection with dispositions and deconsolidations of subsidiary stock and to carry out the principles of *General Utilities* repeal pending the issuance of further guidance. These temporary regulations permit taxpayers to determine the amount of allowable loss or basis reduction by applying § 1.1502–20 in its entirety or, in lieu thereof, by electing to apply the provisions of either § 1.337(d)–2T or 1.1502–20 without regard to § 1.1502–20(c)(1)(iii). In addition, these temporary regulations provide taxpayers with guidance on the effect of elections previously made under § 1.1502–20(g) to reattribute losses to the common parent of a selling group. Accordingly, good cause is found for dispensing with notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with a delayed effective date pursuant to 5 U.S.C. 553(d)(1) and (3).

Because no notice of proposed rulemaking is required, the provisions of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) do not apply.

Drafting Information

The principal authors of these regulations are Sean P. Duffley and Lola L. Johnson, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.337(d)–2T also issued under 26 U.S.C. 337(d). * * *

Section 1.1502–20T(i) also issued under 26 U.S.C. 1502. * * *

Section 1.1502–32T(b)(4)(v) also issued under 26 U.S.C. 1502. * * *

Par. 2. Section 1.337(d)–2 is amended by adding paragraph (g)(4) to read as follows:

§ 1.337(d)–2 Loss limitation window period.

* * * * *

(g) * * *

(4) For dispositions and deconsolidations on and after March 7, 2002, see § 1.337(d)–2T.

Par. 3. Section 1.337(d)–2T is added to read as follows:

§ 1.337(d)–2T Loss limitation window period (temporary).

(a) *Loss disallowance*—(1) *General rule*. No deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary.

(2) *Definitions*. For purposes of this section:

(i) The definitions in § 1.1502–1 apply.

(ii) *Disposition* means any event in which gain or loss is recognized, in whole or in part.

(3) *Coordination with loss deferral and other disallowance rules*. For purposes of this section, the rules of § 1.1502–20(a)(3) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502–20.

(b) *Basis reduction on deconsolidation*—(1) *General rule*. If the basis of a member of a consolidated group in a share of stock of a subsidiary exceeds its value immediately before a deconsolidation of the share, the basis of the share is reduced at that time to an amount equal to its value. If both a disposition and a deconsolidation occur with respect to a share in the same transaction, paragraph (a) of this section applies and, to the extent necessary to effectuate the purposes of this section, this paragraph (b) applies following the application of paragraph (a) of this section.

(2) *Deconsolidation*. *Deconsolidation* means any event that causes a share of stock of a subsidiary that remains outstanding to be no longer owned by a member of any consolidated group of which the subsidiary is also a member.

(3) *Value*. *Value* means fair market value.

(c) *Allowable Loss*—(1) *Application*. This paragraph (c) applies with respect to stock of a subsidiary only if a separate statement entitled "§ 1.337(d)–2T(c) statement" is included with the return in accordance with paragraph (c)(3) of this section.

(2) *General rule*. Loss is not disallowed under paragraph (a)(1) of this section and basis is not reduced under paragraph (b)(1) of this section to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset (including stock and securities). Loss or basis may be attributable to the recognition of built-in gain on the disposition of an asset by a prior group. For purposes of this section, gain recognized on the disposition of an asset is built-in gain to the extent attributable, directly or indirectly, in whole or in part, to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share, directly or indirectly, in whole or in part, after applying section 1503(e) and other applicable provisions of the Internal Revenue Code and regulations.

(3) *Contents of statement and time of filing*. The statement required under paragraph (c)(1) of this section must be included with or as part of the taxpayer's return for the year of the disposition or deconsolidation and must contain:

(i) The name and employer identification number (E.I.N.) of the subsidiary.

(ii) The amount of the loss not disallowed under paragraph (a)(1) of this section by reason of this paragraph (c) and the amount of basis not reduced under paragraph (b)(1) of this section by reason of this paragraph (c).

(4) *Example*. The principles of paragraphs (a), (b), and (c) of this section are illustrated by the examples in §§ 1.337(d)–1(a)(5) and 1.1502–20(a)(5) (other than *Examples 3*, *4*, and *5*) and (b), with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502–20, and by the following example. For purposes of the examples in this section, unless otherwise stated, the group files consolidated returns on a calendar year basis, the facts set forth the only corporate activity, and all sales and purchases are with unrelated buyers or sellers. The basis of each asset is the same for determining earnings and profits adjustments and taxable income. Tax liability and its effect on basis, value, and earnings and profits are disregarded. *Investment adjustment system* means the rules of § 1.1502–32.

Example. Loss offsetting built-in gain in a prior group. (i) P buys all the stock of T for $50 in Year 1, and T becomes a member of the P group. T has 2 assets. Asset 1 has a basis of $50 and a value of $0, and asset 2 has a basis of $0 and a value of $50. T sells asset 2 during Year 3 for $50, and recognizes a $50 gain. Under the investment adjustment system, P's basis in the T stock increased to $100 as a result of the recognition of gain. In Year 5, all of the stock of P is acquired by the P1 group, and the former members of the P group become members of the P1 group. T then sells asset 1 for $0, and recognizes a $50 loss. Under the investment adjustment system, P's basis in the T stock decreases to $50 as a result of the loss. T's assets decline in value from $50 to $40. P then sells all the stock of T for $40 and recognizes a $10 loss.

(ii) P's basis in the T stock reflects both T's unrecognized gain and unrecognized loss with respect to its assets. The gain T recognizes on the disposition of asset 2 is built-in gain with respect to both the P and the P1 groups for purposes of paragraph (c)(2) of this section. In addition, the loss T recognizes on the disposition of asset 2 is built-in loss with respect to the P and P1 groups for purposes of paragraph (c)(2) of this section. T's recognition of the built-in loss while a member of the P1 group offsets the effect on T's stock basis of T's recognition of the built-in gain while a member of the P group. Thus, P's $10 loss on the sale of the T stock is not attributable to the recognition of built-in gain, and the loss is therefore not disallowed under paragraph (c)(2) of this section.

(iii) The result would be the same if, instead of having a $50 built-in loss in asset 2 when it becomes a member of the P group, T has a $50 net operating loss carryover and the carryover is used by the P group.

(d) *Successors*. For purposes of this section, the rules and examples of § 1.1502–20(d) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502–20.

(e) *Anti-avoidance rules*. For purposes of this section, the rules and examples of § 1.1502–20(e) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502–20.

(f) *Investment adjustments*. For purposes of this section, the rules and examples of § 1.1502–20(f) apply, with appropriate adjustments to reflect differences between the approach of this section and that of § 1.1502–20.

(g) *Effective dates*. This section applies with respect to dispositions and deconsolidations on or after March 7, 2002, unless the disposition or deconsolidation was effected pursuant to a binding written contract entered into before March 7, 2002, that was in continuous effect until the disposition or deconsolidation. In addition, this section applies to dispositions and deconsolidations for which an election is made under § 1.1502–20T(i)(2) to determine allowable loss under this section. If loss is recognized because stock of a subsidiary became worthless, the disposition with respect to

the stock is treated as occurring on the date the stock became worthless. For dispositions and deconsolidations prior to March 7, 2002, see §§ 1.337(d)–1 and 1.337(d)–2 as contained in the 26 CFR part 1 edition revised as of April 1, 2001.

Par. 4. In § 1.1502–20, paragraph (i) is added to read as follows:

§ 1.1502–20 Disposition or deconsolidation of subsidiary stock.

* * * * *

(i) [Reserved]. For further guidance, see § 1.1502–20T(i).

Par. 5. Section 1.1502–20T is added to read as follows:

§ 1.1502–20T Disposition or deconsolidation of subsidiary stock (temporary).

(a) through (h) [Reserved]. For further guidance, see § 1.1502–20(a) through (h).

(i) *Limitations on the applicability of § 1.1502–20*—(1) *Dispositions and deconsolidations on or after March 7, 2002*. Except to the extent specifically incorporated in § 1.337(d)–2T, § 1.1502–20 does not apply to a disposition or deconsolidation of stock of a subsidiary on or after March 7, 2002, unless the disposition or deconsolidation was effected pursuant to a binding written contract entered into before March 7, 2002, that was in continuous effect until the disposition or deconsolidation.

(2) *Dispositions and deconsolidations prior to March 7, 2002*. In the case of a disposition or deconsolidation of stock of a subsidiary by a member before March 7, 2002, or a disposition or deconsolidation on or after March 7, 2002, that was effected pursuant to a binding written contract entered into before March 7, 2002, that was in continuous effect until the disposition or deconsolidation, a consolidated group may determine the amount of the member's allowable loss or basis reduction by applying § 1.1502–20 in its entirety, or, in lieu thereof, subject to the conditions set forth in this paragraph (i), by making an irrevocable election to apply the provisions of either—

(i) Section 1.1502–20, except that in applying § 1.1502–20(c)(1), the amount of loss disallowed under § 1.1502–20(a)(1) and the amount of basis reduction under § 1.1502–20(b)(1) with respect to a share of stock will not exceed the sum of the amounts described in § 1.1502–20(c)(1)(i) and (ii); or

(ii) Section 1.337(d)–2T.

(3) *Operating rules*—(i) *Reattribution of losses in the case of an election to determine allowable loss by applying the provisions described in paragraph (i)(2)(i) of this section*. If a consolidated group elects to determine allowable loss by applying the provisions described in paragraph (i)(2)(i) of this section, an election described in § 1.1502–20(g) to reattribute losses will be respected only if the requirements of § 1.1502–20(g), including the requirement that the election be filed with the group's income tax return for the year of the disposition, have been or are satisfied. For example, if a consolidated group did not file a valid election described in § 1.1502–20(g) with its return for the year of the disposition, this section does not authorize the group that disposed of the stock to make such an election with its return for the year in which it elects to determine its allowable stock loss under the provisions described in paragraph (i)(2)(i) of this section. If a consolidated group that made a valid election described in § 1.1502–20(g) with respect to the disposition of stock elects to determine allowable loss by applying the provisions described in paragraph (i)(2)(i) of this section, the election described in § 1.1502–20(g) may not be revoked, and the amount of loss treated as reattributed as of the time of the disposition pursuant to the election described in § 1.1502–20(g) is the amount of loss originally reattributed, reduced to the extent that it exceeds the greater of—

(A) The amount of stock loss disallowed after applying the provisions described in paragraph (i)(2)(i) of this section; and

(B) The amount of reattributed losses that the group that disposed of the stock absorbed in years for which the assessment of a deficiency is prevented by any law or rule of law as of the date the election to apply the provisions described in paragraph (i)(2)(i) of this section is filed and at all times thereafter.

(ii) *Reattribution of losses in the case of an election to determine allowable loss by applying the provisions described in paragraph (i)(2)(ii) of this section*. If a consolidated group elects to determine allowable loss by applying the provisions described in paragraph (i)(2)(ii) of this section, the consolidated group may not make an election described in § 1.1502–20(g) to reattribute any losses. If the consolidated group made an election described in §1.1502–20(g) with respect to the disposition of subsidiary stock, the amount of loss treated as reattributed pursuant to such election will be the greater of—

(A) Zero; and

(B) The amount of reattributed losses that the group that disposed of the stock absorbed in years for which the assessment of a deficiency is prevented by any law or rule of law as of the date the election to apply the provisions described in paragraph (i)(2)(ii) of this section is filed and at all times thereafter.

(iii) *Apportionment of section 382 limitation in the case of a reduction of reattributed losses*—(A) *Losses subject to a separate section 382 limitation*. If, as a result of the application of paragraph (i)(3)(i) or (ii) and paragraph (i)(3)(vii) of this section, pre-change separate attributes that were subject to a separate section 382 limitation are treated as losses of a subsidiary and the common parent previously elected to apportion all or a part of such limitation to itself under § 1.1502–96(d), the common parent may reduce the amount of such limitation apportioned to itself.

(B) *Losses subject to a subgroup section 382 limitation*. If, as a result of the application of paragraph (i)(3)(i) or (ii) and paragraph (i)(3)(vii) of this section, pre-change subgroup attributes that were subject to a subgroup section 382 limitation are treated as losses of a subsidiary and the common parent previously elected to apportion all or a part of such limitation to itself under § 1.1502–96(d), the common parent may reduce the amount of such limitation apportioned to itself. In addition, if such subsidiary has ceased to be a member of the loss subgroup to which the pre-change subgroup attributes relate, the common parent may increase the total amount of such limitation apportioned to such subsidiary (or loss subgroup that includes such subsidiary) under § 1.1502–95(c) by an amount not in excess of the amount by which such limitation that is apportioned to the common parent is reduced pursuant to the previous sentence.

(C) *Losses subject to a consolidated section 382 limitation.* If, as a result of the application of paragraph (i)(3)(i) or (ii) and paragraph (i)(3)(vii) of this section, pre-change consolidated attributes (or pre-change subgroup attributes) that were subject to a consolidated section 382 limitation (or subgroup section 382 limitation where the common parent was a member of the loss subgroup) are treated as losses of a subsidiary, and the subsidiary has ceased to be a member of the loss group (or loss subgroup), the common parent may increase the amount of such limitation that is apportioned to such subsidiary (or loss subgroup that includes such subsidiary) under § 1.1502–95(c). The amount of each element of such limitation that can be apportioned to a subsidiary (or loss subgroup that includes such subsidiary) pursuant to this paragraph (i)(3)(iii)(C), however, cannot exceed the product of (x) the element and (y) a fraction the numerator of which is the amount of pre-change consolidated attributes (or subgroup attributes) subject to that limitation that are treated as losses of the subsidiary (or loss subgroup) as a result of the application of paragraph (i)(3)(i) or (ii) and paragraph (i)(3)(vii) of this section and the denominator of which is the total amount of pre-change attributes subject to that limitation determined as of the close of the taxable year in which the subsidiary ceases to be a member of the group (or loss subgroup).

(D) *Operating rules—(i) Limitations on apportionment.* In making any adjustment to an apportionment of a subgroup section 382 limitation or a consolidated section 382 limitation pursuant to paragraph (i)(3)(iii)(B) or (C) of this section, the common parent must take into account the extent, if any, to which such limitation has previously been apportioned to another subsidiary or loss subgroup prior to the date the election to apply the provisions described in paragraph (i)(2)(i) or (ii) of this section is filed.

(*ii*) *Manner and effect of adjustment to previous apportionment of limitation to common parent.* Any reduction in a previous apportionment of a separate section 382 limitation or a subgroup section 382 limitation to the common parent made pursuant to paragraph (i)(3)(iii)(A) or (B) of this section is treated as effective when the previous apportionment was effective. Any such adjustment must be made in a manner consistent with the principles of § 1.1502–95(c). For example, to the extent the apportionment of a separate section 382 limitation or a subgroup section 382 limitation to a common parent is reduced pursuant to paragraph (i)(3)(iii)(A) or (B) of this section, the amount of such limitation available to the subsidiary or loss subgroup, as applicable, is increased.

(*iii*) *Manner and effect of adjustment to apportionment of limitation to departing subsidiary or loss subgroup.* Any increase in an amount of a subgroup section 382 limitation or a consolidated section 382 limitation apportioned to a departing subsidiary (or loss subgroup that includes such subsidiary) made pursuant to paragraph (i)(3)(iii)(B) or (C) of this section is treated as effective for taxable years ending after the date the subsidiary ceases to be a member of the group or loss subgroup. Any such adjustment may be made regardless of whether the common parent previously elected to apportion all or a part of such limitation to such subsidiary (or loss subgroup that includes such subsidiary) under § 1.1502–95(c) or 1.1502–95A(c), but must be made in a manner consistent with the principles of § 1.1502–95(c). For example, to the extent the apportionment of an element of a subgroup section 382 limitation or a consolidated section 382 limitation to a departing subsidiary is increased pursuant to paragraph (i)(3)(iii)(B) or (C) of this section, the amount of such element of such limitation that is available to the loss subgroup or loss group is reduced consistent with § 1.1502–95(c)(3).

(*iv*) *Prohibition against other adjustments.* This paragraph (i)(3)(iii) does not authorize the common parent to adjust the apportionment of any separate section 382 limitation, subgroup section 382 limitation, or consolidated section 382 limitation that it previously apportioned to a subsidiary, to a loss subgroup, or to itself under § 1.1502–95(c), 1.1502–95A(c), or 1.1502–96(d), other than as provided in paragraphs (i)(3)(iii)(A), (B), and (C) of this section.

(E) *Time and manner of making apportionment adjustment.* An adjustment to the apportionment of any separate section 382 limitation, subgroup section 382 limitation, or consolidated section 382 limitation pursuant to paragraph (i)(3)(iii)(A), (B), or (C) of this section must be made as part of the group's election to apply the provisions of paragraph (i)(2)(i) or (ii) of this section, as described in paragraph (i)(4) of this section.

(iv) *Notification of reduction of reattributed losses and adjustment of apportionment of section 382 limitation.* If the application of paragraph (i)(3)(i) or (ii) of this section results in a reduction of the losses treated as reattributed pursuant to an election described in § 1.1502–20(g), then, prior to the date that the group files its income tax return for the taxable year that includes March 7, 2002, the common parent must send the notification required by this paragraph to the subsidiary, at the subsidiary's last known address. In addition, if the acquirer of the subsidiary stock was a member of a consolidated group at the time of the disposition, the common parent must send a copy of such notification to the person that was the common parent of the acquirer's group at the time of the acquisition, at its last known address. The notification is to be in the form of a statement entitled "Recomputation of Losses Reattributed Pursuant to the Election Described in § 1.1502–20(g)," that is signed by the common parent and that includes the following information—

(A) The name and employer identification number (E.I.N.) of the subsidiary;

(B) The original and the recomputed amount of losses treated as reattributed pursuant to the election described in § 1.1502–20(g); and

(C) If the apportionment of a separate section 382 limitation, a subgroup section 382 limitation, or a consolidated section 382 limitation is adjusted pursuant to paragraph (i)(3)(iii)(A), (B), or (C) of this section, the original and the adjusted apportionment of such limitation.

(v) *Items taken into account in closed years.* An election under paragraph (i)(2) of this section affects a taxpayer's items of income, gain, deduction, or loss only to the extent that the election gives rise,

directly or indirectly, to items or amounts that would properly be taken into account in a year for which an assessment of deficiency or a refund of overpayment, as the case may be, is not prevented by any law or rule of law.

(vi) *Conforming amendments for items previously taken into account in open years.* To the extent that, on any Federal income tax return, the common parent absorbed losses that were reattributed pursuant to an election described in § 1.1502–20(g) and the amount of losses so absorbed is in excess of the amount of losses that are treated as reattributed after application of paragraph (i)(3)(i) or (ii) of this section, or that may be taken into account after any adjustment to an apportionment of a separate section 382 limitation, a subgroup section 382 limitation, or a consolidated section 382 limitation pursuant to paragraph (i)(3)(iii) of this section, such returns must be amended to the greatest extent possible to reflect the reduction in the amount of losses treated as reattributed and any adjustment to the apportionment of such limitation.

(vii) *Availability of losses to subsidiary.* To the extent that any losses of a subsidiary are reattributed to the common parent pursuant to an election described in § 1.1502–20(g), such reattribution is binding on the subsidiary and any group of which the subsidiary is or becomes a member. Therefore, if the subsidiary ceases to be a member of the group, any reattributed losses are not thereafter available to the subsidiary and may not be utilized by the subsidiary or any other group of which such subsidiary is or becomes a member. To the extent that the application of paragraph (i)(3)(i) or (ii) of this section results in a reduction in the amount of losses treated as reattributed to the common parent pursuant to an election described in § 1.1502–20(g), however, losses in the amount of such reduction are available to the subsidiary and may be utilized by the subsidiary or any group of which such subsidiary is a member, subject to applicable limitations (*e.g.*, section 382).

(4) *Time and manner of making the election.* An election to determine allowable loss or basis reduction by applying the provisions described in paragraph (i)(2)(i) or (ii) of this section is made by including the statement required by this paragraph with or as part of the original return for the taxable year that includes the later of March 7, 2002, and the date of the disposition or deconsolidation of the stock of the subsidiary, or with or as part of an amended return filed before the date the original return for the taxable year that includes March 7, 2002, is due. The statement shall be entitled "Allowed Loss under Section [Specify Section under Which Allowed Loss Is Determined] Pursuant to Section 1.1502–20T(i)" and must include the following information—

(i) The name and employer identification number (E.I.N.) of the subsidiary and of the member(s) that disposed of the subsidiary stock;

(ii) In the case of an election to determine allowable loss or basis reduction by applying the provisions described in paragraph (i)(2)(i) of this section, a statement that the taxpayer elects to determine allowable loss or basis reduction by applying such provisions;

(iii) In the case of an election to determine allowable loss or basis reduction by applying the provisions described in paragraph (i)(2)(ii) of this section, a statement that the taxpayer elects to determine allowable loss or basis reduction by applying such provisions;

(iv) If an election described in § 1.1502–20(g) was made with respect to the disposition of the stock of the subsidiary, the amount of losses originally treated as reattributed pursuant to such election and the amount of losses treated as reattributed pursuant to paragraph (i)(3)(i) or (ii) of this section;

(v) If an apportionment of a separate section 382 limitation, a subgroup section 382 limitation, or a consolidated section 382 limitation is adjusted pursuant to paragraph (i)(3)(iii)(A), (B), or (C) of this section, the original and redetermined apportionment of such limitation; and

(vi) If the application of paragraph (i)(3)(i) or (ii) of this section results in a reduction of the amount of losses treated as reattributed pursuant to an election described in § 1.1502–20(g), a statement that the notification described in paragraph (i)(3)(iv) of this section was sent to the subsidiary and, if the acquirer was a member of a consolidated group at the time of the stock sale, to the person that was the common parent of such group at such time, as required by paragraph (i)(3)(iv) of this section.

(5) *Cross references.* See § 1.1502–32(b)(4)(v) for a special rule for filing a waiver of loss carryovers.

Par 6. Section 1.1502–32 is amended by adding paragraph (b)(4)(v) to read as follows:

§ 1.1502–32 Investment adjustments.

* * * * *

(b) * * *

(4) * * *

(v) [Reserved]. For further guidance, see § 1.1502–32T(b)(4)(v).

Par. 7. Section 1.1502–32T is added to read as follows:

§ 1.1502–32T Investment adjustments (temporary).

(a) through (b)(4)(iv) [Reserved]. For further guidance, see § 1.1502–32(a) through (b)(4)(iv).

(v) *Special rule for loss carryovers of a subsidiary acquired in a transaction for which an election under § 1.1502–20T(i)(2) is made*—(A) *Expired losses.* Notwithstanding § 1.1502–32(b)(4)(iv), to the extent that S's loss carryovers are increased by reason of an election under § 1.1502–20T(i)(2) and such loss carryovers expire or would have been properly used to offset income in a taxable year for which the refund of an overpayment is prevented by any law or rule of law as of the date the group files its original return for the taxable year in which S receives the notification described in § 1.1502–20T(i)(3)(iv) and at all times thereafter, the group will be deemed to have made an election under § 1.1502–32(b)(4) to treat all of such expired loss carryovers as expiring for all Federal income tax purposes immediately before S became a member of the consolidated group.

(B) *Available losses.* Notwithstanding § 1.1502–32(b)(4)(iv), to the extent that S's loss carryovers are increased by reason of an election under § 1.1502–20T(i)(2) and such loss carryovers have not expired and would not have been properly used to offset income in a taxable year for which the refund of an overpayment is prevented by any law or rule of law as of the date the group files its original return for the taxable year in which S receives the notification described in § 1.1502–20T(i)(3)(iv) and at all times thereafter, the group may

make an election under § 1.1502–32(b)(4) to treat all or a portion of such loss carryovers as expiring for all Federal income tax purposes immediately before S became a member of the consolidated group. Such election must be filed with the group's original return for the taxable year in which S receives the notification described in § 1.1502–20T(i)(3)(iv).

(C) *Effective date.* This paragraph (b)(4)(v) is applicable on and after March 7, 2002.

(c) through (h)(5)(ii) [Reserved]. For further guidance, see § 1.1502–32(c) through (h)(5)(ii).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8 The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 9. In § 602.101, paragraph (b) is amended by adding entries to the table in numerical order to read in part as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.337(d)–2T	1545–1774
* * * * *	
1.1502–20T	1545–1774
* * * * *	
1.1502–32T	1545–1774
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved February 27, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 7, 2002, 3:17 p.m., and published in the issue of the Federal Register for March 12, 2002, 67 F.R. 11034)

Section 446.—General Rule for Methods of Accounting.

26 CFR 1.446–1: General rule for methods of accounting.

A safe harbor method of accounting (the "replacement cost method") is provided for automobile dealers to approximate the cost of their vehicle parts inventory using the replacement cost of the parts. Procedures are also provided for automobile dealers to obtain the automatic consent of the Commissioner to change to the replacement cost method. See Rev. Proc. 2002–17, page 676.

Procedures are provided for Service-imposed accounting method changes and for accounting method issues resolved on a nonaccounting-method-change basis. See Rev. Proc. 2002–18, page 678.

Procedures are provided under which certain taxpayers under examination or before appeals or a federal court may obtain consent to change a method of accounting prospectively without audit protection. See Rev. Proc. 2002–19, page 696.

Section 471.—General Rule for Inventories

26 CFR 1.471–3: Inventories at cost.

A safe harbor method of accounting (the "replacement cost method") is provided for automobile dealers to approximate the cost of their vehicle parts inventory using the replacement cost of the parts. See Rev. Proc. 2002–17, page 676.

Section 481.—Adjustments Required by Changes in Method of Accounting

26 CFR 1.481–1: Adjustments in general.

Procedures are provided for automobile dealers to obtain the automatic consent of the Commissioner to use a safe harbor "replacement cost method" determining the cost of vehicle parts inventory. This change is made without a § 481 (a) adjustment. See Rev. Proc. 2002–17, page 676.

Procedures are provided for Service-imposed accounting method changes and for accounting method issues resolved on a nonaccounting-method-change basis. See Rev. Proc. 2002–18, page 678.

The period for taking into account a net negative adjustment under section 481(a) of the Code resulting from an accounting method change is reduced from 4 years to 1 year. Certain other conforming changes are made to Rev. Proc. 97–27 and Rev. Proc. 2002–9. See Rev. Proc. 2002–19, page 696.

Some of the most significant and prevalent comments received in connection with Notice 98–31, which proposed procedures for Service-imposed accounting method changes, and for resolving accounting method issues on a nonaccounting-method-change basis, are discussed. See Announcement 2002–37, page 703.

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 471, 472, 481; 1.446–1, 1.471–3(d), 1.472–8, 1.481–1.)

Rev. Proc. 2002–17

SECTION 1. PURPOSE

This revenue procedure provides automobile dealers (as defined in section 3 of this revenue procedure) with a safe harbor method of accounting for their vehicle parts inventory. This safe harbor method permits automobile dealers to approximate the cost of their vehicle parts inventory using the replacement cost of the vehicle parts pursuant to the replacement cost method described in section 4 of this revenue procedure. This revenue procedure also provides procedures for automobile dealers to obtain the automatic consent of the Commissioner to change to the replacement cost method.

SECTION 2. BACKGROUND

.01 Section 471 of the Internal Revenue Code provides that inventories must be taken on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

.02 Section 1.471–3(d) of the Income Tax Regulations provides that in any industry in which the usual rules for computation of cost are inapplicable, cost may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry.

.03 Section 472(a) provides that a taxpayer may use the last-in, first-out (LIFO) inventory method. Under the LIFO inventory method, a taxpayer treats those goods remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year. The change to, and use of, the LIFO inventory method must be in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

.04 Section 472(b)(2) provides that a taxpayer using the LIFO inventory method must inventory its goods at cost.

.05 Section 1.472–8(a) provides that a taxpayer may elect to determine the cost of its LIFO inventories under the dollar-value LIFO method, provided such method is used consistently and clearly reflects the income of the taxpayer in accordance with the rules of that section.

.05 Section 1.472–8(e)(2)(ii) provides that the total current-year cost of items making up a dollar-value LIFO pool may be determined: (a) by reference to the actual cost of the goods most recently purchased or produced; (b) by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition; (c) by application of an average unit cost equal to the aggregate cost of all the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or (d) pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

.06 Section 263A generally requires direct costs and an allocable portion of indirect costs of certain property produced or acquired for resale by a taxpayer to be included in inventory costs, in the case of property that is inventory, or to be capitalized, in the case of other property. Section 1.263A–1(e)(2)(ii) provides that resellers must capitalize the acquisition costs of property acquired for resale. In addition, resellers must capitalize the indirect costs described in §1.263A–1(e)(3), which are properly allocable to property acquired for resale. These indirect costs often include purchasing, handling, and storage costs. See § 1.263A–3(c)(1).

.07 In *Mountain State Ford v. Commissioner*, 112 T.C. 58 (1999), the Tax Court held that a taxpayer that sold heavy truck parts and used the dollar-value LIFO method to account for its parts inventory was not entitled to determine the current-year cost of the parts in its ending inventory by reference to their replacement cost. In so doing, the court found that the taxpayer's replacement cost method was not in accordance with the method elected on its Form 970, *Application to Use LIFO Inventory Method*. The taxpayer's Form 970 indicated that it would determine the current-year cost of the items in its ending inventory by reference to the actual cost of the goods most recently purchased or produced in accordance with § 1.472–8(e)(2)(ii)(a). The court further concluded that even if the taxpayer had elected to use another proper method under § 1.472–8(e)(2)(ii)(d), it could not use the replacement cost of the parts to determine current-year cost because replacement cost does not determine current-year cost on the basis of, or by reference to, actual cost (or in some instances a reasonable approximation of actual cost) in accordance with § 472(b).

.08 Subsequent to the *Mountain State Ford* decision, the Service has given careful consideration to the following unique circumstances surrounding the use of replacement cost by automobile dealers:

(1) *Industry practice*. It has been the long-standing and widespread practice of automobile dealers to use replacement cost to determine the cost of their vehicle parts inventory both for financial accounting and federal income tax purposes.

(2) *Use of replacement cost required by third party*. Automobile dealers are commonly required by their franchisors (*i.e.*, the vehicle's manufacturer) to value their vehicle parts inventory using replacement cost, rather than actual cost.

(3) *Substantial burden associated with switching to actual cost*. The automobile dealer industry has represented that automobile dealers that are presently using replacement cost to value their vehicle parts inventory likely would incur substantial expense if they were required to modify their existing recordkeeping systems to determine the cost of such inventory using actual cost.

(4) *Replacement cost approximates actual cost in this industry*. The automobile dealer industry has provided data to demonstrate that, on average, in their industry, due to relatively low inflation and high inventory turnover, the replacement cost of vehicle parts approximates the actual cost of such parts.

Consideration of these factors has led the Service to conclude that, for reasons of administrative convenience, burden reduction, and avoidance of further controversy in this area, a safe harbor method of accounting to determine the cost of vehicle parts inventory using replacement cost to approximate actual cost should be provided to automobile dealers. Accordingly, a safe harbor method is provided in section 4 of this revenue procedure and is available to automobile dealers that satisfy the requirements of this revenue procedure. The Service also is willing to consider requests of other industries for similar safe harbors if the facts of those industries are similar to those described above.

SECTION 3. SCOPE

This revenue procedure applies to any taxpayer that is engaged in the trade or business of selling vehicle parts at retail and that is authorized under an agreement with one or more vehicle manufacturers or distributors to sell new automobiles or new light, medium, or heavy-duty trucks ("automobile dealer").

SECTION 4. REPLACEMENT COST METHOD

.01 *In General.* A taxpayer that is within the scope of this revenue procedure is permitted to use the replacement cost method to approximate the actual cost of its vehicle parts inventory. Under the replacement cost method, a taxpayer must determine the cost of the vehicle parts in its inventory by reference to the replacement cost of the vehicle parts as defined in section 4.02 of this revenue procedure, determine the replacement cost using a standard price list as defined in section 4.03 of this revenue procedure, and satisfy the book conformity requirement as described in section 4.04 of this revenue procedure. Taxpayers within the scope of this revenue procedure may use the replacement cost method in conjunction with either the first-in, first-out inventory method or the LIFO inventory method. Taxpayers that use the replacement cost method provided by this section 4 and that are subject to the provisions of § 263A must include in inventory costs the additional amounts that are required by §§ 1.263A–1 and 1.263A–3 (*e.g.*, freight costs).

.02 *Replacement Cost.* Replacement cost means the amount provided in a standard price list at which a vehicle part may be purchased by the taxpayer on the date of the inventory. If, on the date of the inventory, the vehicle part is not provided in a standard price list, the replacement cost for the part is equal to the last amount provided in a standard price list (*i.e.*, the price at which the part was last offered for purchase in a standard price list).

.03 *Use of Standard Price List.* A "standard price list" is a price list that is widely recognized and used for business purposes in the automobile dealer industry and that is used by the taxpayer in the ordinary course of its business to purchase the vehicle parts for which it is determining the cost.

.04 *Book Conformity.* A taxpayer satisfies the book conformity requirement if it determines the cost of vehicle parts in its inventory using the replacement cost of the vehicle parts as defined in section 4.02 when it ascertains the income, profit, or loss of its trade or business for purposes of its books, records, and reports (including financial statements) to its shareholders, partners, other proprietors, beneficiaries, and creditors.

SECTION 5. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING THE REPLACEMENT COST METHOD

A taxpayer within the scope of this revenue procedure that is using the replacement cost method provided in section 4 of this revenue procedure on March 12, 2002, may continue to use this safe harbor method for taxable years ending on or after March 12, 2002, without filing a Form 3115, *Application for Change in Accounting Method.* Such taxpayer's method of using replacement cost to determine cost for its vehicle parts inventory will not be raised as an issue in a taxable year that ends before December 31, 2001. Moreover, if such taxpayer's method of using replacement cost to determine cost for its vehicle parts inventory is already an issue under consideration in a taxable year that ends before December 31, 2001, the issue will not be further pursued.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

.01 *In General.* A change to the replacement cost method provided by this revenue procedure is a change in method of accounting to which the provisions of § 446 and the regulations thereunder apply. Therefore, a taxpayer within the scope of this revenue procedure that does not use the replacement cost method provided in section 4 of this revenue procedure on March 12, 2002, but wants to use this safe harbor method for a taxable year ending on or after December 31, 2001, must file a Form 3115.

.02 *Automatic change to the replacement cost method.* A taxpayer within the scope of this revenue procedure that wants to change its method of determining cost to the replacement cost method provided by this revenue procedure must follow the automatic change in accounting method provisions of Rev. Proc. 2002–9 (2002–3 I.R.B. 327) with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply to a taxpayer that wants to make the change for its first or second taxable year ending on or after December 31, 2001;

(2) A change to the replacement cost method under the provisions of Rev. Proc. 2002–9 must be effected on a cut-off method. Thus, the change in method of accounting is made without a § 481(a) adjustment;

(3) A taxpayer making a change under this section 6.02 of this revenue procedure for its first taxable year ending on or after December 31, 2001, that before April 11, 2002, filed its original federal income tax return for such year is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002–9, provided the taxpayer complies with the following filing requirement. The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to an amended federal income tax return for the taxpayer's first taxable year ending on or after December 31, 2001. This amended return must be filed no later than September 9, 2002. A copy of the Form 3115 must be filed with the national office (see section

6.02(6) of Rev. Proc. 2002–9) no later than when the taxpayer's amended return is filed; and

(4) When filing the Form 3115, taxpayers must complete all applicable parts of the form and, in lieu of the label required by section 6.02(4) of Rev. Proc. 2002–9, are instructed to write "Filed under Rev. Proc. 2002–17" at the top of the form.

.03 *Audit Protection.* If a taxpayer complies with the requirements of this revenue procedure and changes its method of determining cost for its vehicle parts inventory to the replacement cost method provided in section 4 of this revenue procedure, the taxpayer will receive audit protection for any taxable year before the year of change with respect to the taxpayer's method of determining cost for its vehicle parts inventory under § 471 or 472. See section 7 of Rev. Proc. 2002–9. However, if this change in method of accounting is made for the taxpayer's first or second taxable year ending on or after December 31, 2001, and the taxpayer's method of determining cost (other than by use of replacement cost) for its vehicle parts inventory under § 471 or 472 is an issue under consideration as of March 12, 2002, in a taxable year that ends before December 31, 2001, the taxpayer will not receive audit protection.

SECTION 7. RECORD KEEPING

Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. The books or records required by § 6001 must be kept at all times available for inspection by authorized internal revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any internal revenue law. Section 1.6001–1(e). In order to satisfy the record keeping requirements of § 6001 and the regulations thereunder, a taxpayer that uses the replacement cost method should maintain records supporting all aspects of its inventory valuation including, but not limited to, the price list described in section 4 of this revenue procedure.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified and amplified to include this automatic change in section 10.02 of the APPENDIX.

SECTION 9. EFFECTIVE DATE

This revenue procedure generally is effective for taxable years ending on or after December 31, 2001.

DRAFTING INFORMATION

The principal author of this revenue procedure is Scott Rabinowitz of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Rabinowitz at (202) 622–4970 (not a toll-free number).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part 1, §§ 446, 481; 1.446–1, 1.481–1)

Rev. Proc. 2002–18

DRAFTING INFORMATION

SECTION 1. PURPOSE

.01 *In General*. This revenue procedure provides the procedures under § 446(b) of the Internal Revenue Code and § 1.446–1(b) of the Income Tax Regulations for changes in method of accounting imposed by the Internal Revenue Service (Service). This revenue procedure also provides the procedures that the Service will use for accounting method issues resolved by the Service on a nonaccounting-method-change basis.

.02 *Voluntary Compliance*. This revenue procedure provides terms and conditions for Service-imposed changes in method of accounting that are intended to encourage taxpayers to voluntarily request a change from an impermissible method of accounting prior to being contacted for examination. Under this approach, a taxpayer that is contacted for examination and required to change its method of accounting by the Service ("involuntary change") generally receives less favorable terms and conditions when the change results in a positive § 481(a) adjustment than the taxpayer would have received if it had filed an application to change its method of accounting ("voluntary change") before the taxpayer was contacted for examination. For example, an involuntary change generally is made with an earlier year of change and a shorter § 481(a) adjustment period for a positive adjustment, and a voluntary change generally is made with a current year of change and a longer § 481(a) adjustment period for a positive adjustment. *See* Rev. Proc. 97–27 (1997–1 C.B. 680) as modified by Rev. Proc. 2002–19 (2002–13 I.R.B. 696) and Rev. Proc. 2002–9 (2002–3 I.R.B. 327) as modified by Ann. 2002–17 (2002–8 I.R.B. 561), and Rev. Proc. 2002–19 (2002–13 I.R.B. 696) which provide the procedures for voluntary requests to change an accounting method.

.03 *Procedures for Examination, Appeals, and Counsel for the Government for Resolving Accounting Method Issues*. This revenue procedure sets forth procedures for Examination, Appeals, and counsel for the government to resolve accounting method issues. It does not alter Examination's authority to examine the returns of a taxpayer. It provides parameters for Examination to resolve accounting method issues, but does not limit or expand Examination's authority to resolve any issues under any applicable

Delegation Order (*e.g.*, Delegation Order No. 236, Application of Appeals Settlement to Coordinated Examination Program Taxpayers, and Delegation Order No. 247, Authority of Examination Case Managers to Accept Settlement Offers and Execute Closing Agreements on Industry Specialization Program and International Field Assistance Program Issues). This revenue procedure also does not alter or limit the authority of Appeals or counsel for the government to resolve or settle any issues.

SECTION 2. BACKGROUND

.01 *Change in Method of Accounting Defined.*

(1) Section 1.446–1(e)(2)(ii)(a) provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. *See* Rev. Proc. 91–31 (1991–1 C.B. 566).

(2) Although a method of accounting may exist under this definition without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446–1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer has adopted a method of accounting for that item. If a taxpayer has adopted a method of accounting under these rules, the taxpayer may not change the method by amending its prior income tax returns(s). *See* Rev. Rul. 90–38 (1990–1 C.B. 57). Rather, a taxpayer that wants to change its method of accounting must follow either the automatic method change procedures of Rev. Proc. 2002–9 (or its successor), if applicable, or the advance consent procedures of Rev. Proc. 97–27 (or its successor).

(3) Section 1.446–1(e)(2)(ii)(*b*) of the regulations provides examples of circumstances that do not constitute changes in method of accounting, including:

(a) correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit);

(b) adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item or the taking of a deduction; and

(c) a change in treatment resulting from a change in underlying facts.

.02 *Method Changes Imposed by the Service.*

(1) Section 446(b) and § 1.446–1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in the manner that, in the opinion of the Commissioner, does clearly reflect income.

(2) The Commissioner has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979); *RCA Corp. v. United States*, 664 F.2d 881 (2nd Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982).

(3) The Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer once the Commissioner has determined that the taxpayer's method of accounting does not clearly reflect income, and the Commissioner's selection may be challenged only upon showing an abuse of discretion by the Commissioner. *See Wilkinson-Beane, Inc. v. Commissioner*, 420 F.2d 352 (1st Cir. 1970); *Standard Paving Co. v. Commissioner*, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951).

(4) The Commissioner has the discretion to change a taxpayer's method of accounting even though the Commissioner previously changed the taxpayer to the method if the Commissioner determines that the method of accounting does not clearly reflect the taxpayer's income. The Commissioner is not precluded from correcting mistakes of law in determining a taxpayer's tax liability, including the power to retroactively correct rulings or other determinations on which the taxpayer may have relied. *See Dixon v. United States*, 381 U.S. 68 (1965); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957); *Massaglia v. Commissioner*, 286 F.2d 258 (10th Cir. 1961).

(5) The Commissioner does not have discretion, however, to require a taxpayer to change from a method of accounting that clearly reflects income to a method that, in the Commissioner's view, more clearly reflects income. *See Capitol Federal Savings & Loan v. Commissioner*, 96 T.C. 204 (1991); *W.P. Garth v. Commissioner*, 56 T.C. 610 (1971), *acq.*, 1975–1 C.B. 1.

(6) The Commissioner may change the accounting method of a taxpayer that is under examination, before an appeals office, or before a federal court, except as otherwise provided in published guidance. See, for example, section 9 of Rev. Proc. 97–27, which generally precludes the Service from changing a taxpayer's method of accounting for an item for prior taxable years if the taxpayer timely files a Form 3115, *Application to Change a Method of Accounting*, pursuant to Rev. Proc. 97–27 requesting to change its method of accounting for the item.

.03 *No Right to Retroactive Method Change.* Although the Commissioner is authorized to consent to a retroactive accounting method change, a taxpayer does not have a right to a retroactive change, regardless of whether the change is from a permissible or impermissible method. *See generally*, Rev. Rul. 90–38.

.04 *Method Change With a § 481(a) Adjustment.*

(1) *Need for adjustment.* Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting

different from the method used to compute taxable income for the preceding taxable year. When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then used, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Example. A taxpayer, although not permitted to use the cash receipts and disbursements method of accounting by § 448, uses the overall cash method and changes to an overall accrual method. The taxpayer has $120,000 of income earned but not yet received (accounts receivable) and $100,000 of expenses incurred but not yet paid (accounts payable) as of the end of the taxable year preceding the year of change. A positive § 481(a) adjustment of $20,000 ($120,000 accounts receivable less $100,000 accounts payable) is required as a result of the change.

(2) *Adjustments attributable to pre-1954 years*. Section 481(a)(2) and § 1.481–3 provide that if the adjustments required by § 481(a) are attributable to a change in method of accounting not initiated by the taxpayer, no portion of any adjustments which is attributable to pre-1954 taxable years is taken into account in computing taxable income.

(3) *Adjustment period*. Section 481(c) and §§ 1.446–1(e)(3)(i) and 1.481–4 provide that the adjustment required by § 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer. Generally, in the absence of such an agreement, the § 481(a) adjustment is taken into account in computing taxable income completely in the year of change. However, § 481(b) may limit the amount of tax attributable to a substantial § 481(a) adjustment that increases taxable income.

.05 *Method Change Using a Cut-off Method*. The Commissioner may determine that certain changes in method of accounting will be made without a § 481(a) adjustment, using a "cut-off method." Under a cut-off method, only the items arising on or after the beginning of the year of change are accounted for under the new method of accounting. Any items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting. Because no items are duplicated or omitted from income when a cut-off method is used to effect a change in accounting method, no § 481(a) adjustment is necessary.

.06 *Previous Method Change Without Consent*. The Commissioner may require a taxpayer that has changed a method of accounting without the Commissioner's consent to change back to its former method. The Commissioner may do so even when the taxpayer changed from an impermissible to a permissible method. The change back to the former method may be made in the taxable year the taxpayer changed without consent, or if that year is closed by the running of the period of limitations, in the earliest open year. *See Commissioner v. O. Liquidating Corp.*, 292 F.2d 225 (3rd Cir.), *cert. denied*, 368 U.S. 898 (1961); *Wright Contracting Co. v. Commissioner*, 316 F.2d 249 (5th Cir., 1963), *cert. denied* 375 U.S. 879 (1963), *reh'g denied* 375 U.S. 981 (1964), *acq.* 1966–2 C.B. 7; *Daktronics, Inc. v. Commissioner*, T.C. Memo. 1991–60; *Handy Andy T.V. and Appliances, Inc. v. Commissioner*, T.C. Memo. 1983–713. For example, the Service may change a taxpayer back to its former impermissible method of accounting if the taxpayer changed to a permissible method of accounting without the Commissioner's consent and miscalculated the § 481(a) adjustment, even where the statute of limitations has expired for the year of change.

.07 *Penalties*. Any otherwise applicable penalty for the failure of a taxpayer to change its method of accounting (for example, the accuracy-related penalty under § 6662 or the fraud penalty under § 6663) may be imposed if the Service imposes an accounting method change. *See* § 446(f). Additionally, the taxpayer's return preparer may also be subject to the preparer penalty under § 6694.

SECTION 3. DEFINITIONS

.01 *Accounting Method Issue*. The term "accounting method issue" means an issue regarding whether the taxpayer's accounting treatment of an item is proper, but only if changing the taxpayer's treatment of such item could constitute a change in method of accounting. See the definition of change in method of accounting in § 1.446–1(e)(2) and section 2.01 of this revenue procedure.

.02 *Year of Change*. The year of change is the taxable year for which a change in method of accounting is effective, that is, the first taxable year the new method is used, even if no affected items are taken into account for that year. The year of change is also the first taxable year for complying with all the terms and conditions accompanying the change.

.03 *Section 481(a) Adjustment Period*. The § 481(a) adjustment period is the applicable number of taxable years for taking into account the § 481(a) adjustment required as a result of the change in method of accounting. The year of change is the first taxable year in the adjustment period and the § 481(a) adjustment is taken into account ratably over the number of taxable years in the adjustment period.

.04 *Taxpayer*. The term "taxpayer" has the same meaning as the term "person" defined in § 7701(a)(1) (rather than the meaning of the term "taxpayer" defined in § 7701(a)(14)).

SECTION 4. SCOPE

Except as otherwise provided in published guidance, this revenue procedure applies to any accounting method change imposed by the Service, and to any accounting method issue resolved by the Service on a nonaccounting-method-change basis.

SECTION 5. EXAMINATION DISCRETION TO RESOLVE ACCOUNTING METHOD ISSUES

.01 *In General*. Using professional judgment in accordance with auditing standards, an examining agent will make findings of fact and apply Service position on issues of law to determine whether an issue is an accounting method issue (as defined by section 3.01 of this revenue procedure) and whether the taxpayer's method of accounting is permissible. *See* Policy Statement P–4–117. Except as otherwise provided in published guidance (for example, Delegation Order No. 236), the discretion of an examining agent to resolve an accounting method issue is set forth in sections 5.02 through 5.06 of this revenue procedure.

See section 10.01 of this revenue procedure for an example of the application of section 5 of this revenue procedure.

.02 *Requirement to Treat an Accounting Method Issue as a Method Change.* An examining agent who determines that a taxpayer's method of accounting is impermissible, or that a taxpayer changed its method of accounting without obtaining the consent of the Commissioner, may propose an adjustment with respect to that method only by changing the taxpayer's method of accounting.

.03 *Selection of New Method of Accounting.* Except as provided in section 2.06 of this revenue procedure, an examining agent changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts determined by the agent. The method selected must be a proper method of accounting and will not be a method contrived to reflect the hazards of litigation.

Example. A taxpayer held long-term zero coupon bonds during the taxable year under examination but did not include any original issue discount (OID) in income for that year. The examining agent determines that the taxpayer should have included OID in income for that year under § 1272. Accordingly, the examining agent will change the taxpayer's method of accounting to include the OID in income in accordance with § 1272 and the regulations thereunder. The examining agent will not impose a method of accounting that is designed to take into account litigation hazards (for example, a method that only requires the accrual of an arbitrary percentage of the OID that would otherwise accrue during the year under § 1272 and the regulations thereunder).

.04 *Terms and Conditions of Change.*

(1) *Year of change.* An examining agent changing a taxpayer's method of accounting will make the change in a year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible. However, in appropriate circumstances, an examining agent may defer the year of change to a later taxable year. For example, an examining agent may defer the year of change if the examining agent determines that:

(a) the taxpayer's books and records do not contain sufficient information to compute a § 481(a) adjustment for the taxable year in which the change would otherwise be imposed and the adjustment cannot be reasonably estimated;

(b) the taxpayer's existing method of accounting does not have a material effect for the taxable year in which the change would otherwise be imposed; or

(c) there are taxable years for which the statute of limitations has expired following the taxable year in which the change would otherwise be imposed.

An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change.

(2) *Section 481(a) adjustment.* An examining agent changing a taxpayer's method of accounting ordinarily will impose a § 481(a) adjustment, subject to a computation of tax under § 481(b)(if applicable). However, an examining agent should use a cut-off method to make a change (other than a change within the LIFO inventory method as defined in section 3.09 of Revenue Procedure 97–27 (1997–1 C.B. 680), or a change in method of accounting for intercompany transactions, *see* § 1.1502–13) when a statute, regulation, or administrative pronouncement of the Service effective for the year of change directs that the change be made using a cut-off method. *See, e.g.*, § 174. In addition, an examining agent may use a cut-off method to make a change in appropriate circumstances. For example, the examining agent may use a cut-off method to make a change if the agent determines that the taxpayer's books and records do not contain sufficient information to compute a § 481(a) adjustment and the adjustment cannot be reasonably estimated. Finally, an examining agent will not make a change on a cut-off method in order to reflect the hazards of litigation.

(3) *Spread of § 481(a) adjustment.* The § 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change.

SECTION 6. APPEALS AND COUNSEL FOR THE GOVERNMENT DISCRETION TO RESOLVE ACCOUNTING METHOD ISSUES

.01 *Authority to Resolve Accounting Method Issues.* An appeals officer or counsel for the government may resolve an accounting method issue (as defined by section 3.01 of this revenue procedure) when it is in the interest of the government to do so. *See* P–8-47.

.02 *Types of Resolutions.*

(1) *In general.* An appeals officer or counsel for the government may resolve an accounting method issue by using any of the means described in section 6 of this revenue procedure, or any other means deemed appropriate under the circumstances, to reflect the hazards of litigation. See sections 10.02 through 10.04 of this revenue procedure for examples of the application of section 6 of this revenue procedure.

(2) *Accounting method changes.*

(a) *Treating an accounting method issue as a method change.* An appeals officer or counsel for the government resolving an accounting method issue may treat the issue as a change in method of accounting.

(b) *Selection of new method of accounting.* Except as provided in section 2.06 of this revenue procedure, an appeals officer or counsel for the government changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts. The appeals officer or counsel for the government will not put the taxpayer on an improper method of accounting in order to reflect the hazards of litigation.

(c) *Terms and conditions of change.* An appeals officer or counsel for the government changing a taxpayer's method of accounting may agree to terms and conditions that differ from those ordinarily applicable to an Examination-imposed accounting method change, including the following (or any combination thereof):

(i) *Year of change.* An appeals officer or counsel for the government may compromise the year of change (for example, by agreeing to a later year of change). However, an appeals officer or counsel for the government changing a taxpayer's method of accounting ordinarily will not defer the year of change to

later than the most recent taxable year under examination on the date of the agreement finalizing the change, and, in no event, will defer the year of change to later than the taxable year that includes the date of the agreement finalizing the change;

(ii) *Section 481(a) adjustment.* An appeals officer or counsel for the government may make the change using a § 481(a) adjustment or a cut-off method. If a § 481(a) adjustment is used, the appeals officer or counsel for the government may compromise the amount of the § 481(a) adjustment (for example, by agreeing to a reduced § 481(a) adjustment). If the appeals officer or counsel for the government agrees to compromise the amount of the § 481(a) adjustment, the agreement must be in writing; and

(iii) *Spread of the § 481(a) adjustment.* An appeals officer or counsel for the government may compromise the § 481(a) adjustment period (for example, by agreeing to a longer § 481(a) adjustment period).

(3) *Alternative-timing resolution.* In lieu of changing a taxpayer's method of accounting, an appeals officer or counsel for the government may resolve an accounting method issue by agreeing to alternative timing for all or some of the items arising during, or prior to and during, the taxable years before Appeals or a federal court. The resolution of an accounting method issue on an alternative-timing basis for certain items will not affect the taxpayer's method of accounting for any items not covered by the resolution.

Example. The Service and the taxpayer agree that the taxpayer will capitalize the inventoriable costs incurred during 1999 that were deducted under the taxpayer's method of accounting. The taxpayer's inventoriable costs covered by the agreement must be capitalized and accounted for under the taxpayer's inventory method. The inventoriable costs that are not covered by the agreement (that is, those costs incurred in taxable years prior and subsequent to 1999) are not affected by the resolution and thus, consistent with the taxpayer's method of accounting, must continue to be deducted.

(4) *Time-value of money resolution.*

(a) *In general.* In lieu of changing a taxpayer's method of accounting, an appeals officer or counsel for the government may resolve an accounting method issue by agreeing that the taxpayer will pay the government a "specified amount" that approximates the time-value-of-money benefit the taxpayer has derived from using its method of accounting for the taxable years before appeals or a federal court (instead of the method of accounting determined by the appeals officer or counsel for the government to be the proper method of accounting), reduced by an appropriate factor to reflect the hazards of litigation. If the sum of the time-value-of-money benefit (detriment) computed with respect to each taxable year is negative, the specified amount will be zero and no refund will be made to the taxpayer. The specified amount is not interest under § 163(a), and may not be deducted or capitalized under any provision of the Code. In appropriate circumstances, however, the computation of the specified amount may be tax affected to reflect the approximate effect of a hypothetical tax deduction, as demonstrated in the sample computation. See section 6.02(4)(b)(ii)(B) of this revenue procedure. The specified amount will be treated as a miscellaneous payment as described in the Internal Revenue Manual.

(b) *Computation of specified amount.*

(i) *In general.* An appeals officer or counsel for the government may use any reasonable manner to compute the specified amount, including the sample computation described in section 6.02(4)(b)(ii) of this revenue procedure, or a computation that takes into account the taxpayer's actual tax rates and tax attributes.

(ii) *Sample computation.* Under the sample computation, the specified amount equals the sum of the time-value-of-money benefit (detriment) computed with respect to each taxable year before Appeals or a federal court. The time-value-of-money benefit (detriment) with respect to each taxable year before Appeals or a federal court equals the "hypothetical underpayment (overpayment)" (as defined in section 6.02(4)(b)(ii)(A) of this revenue procedure), multiplied by the "applicable time-value rate" (as defined in section 6.02(4)(b)(ii)(B) of this revenue procedure), compounded daily for the "applicable period" (as defined in section 6.02(4)(b)(ii)(C) of this revenue procedure).

(A) *Hypothetical underpayment (overpayment).* The hypothetical underpayment (overpayment) for each taxable year before Appeals or a federal court is equal to the net increase or decrease in taxable income (including the § 481(a) adjustment) that would have been reflected on the return for the taxable year if the Service had changed the taxpayer's method of accounting (in the earliest taxable year before Appeals or a federal court, or, if later, the first taxable year the method is considered impermissible), multiplied by the applicable tax rate for the taxable year of the underpayment (overpayment). For this purpose, only adjustments associated with the change are taken into account. The applicable tax rate is the highest rate of income tax applicable to the taxpayer (for example, the highest rate in effect under § 1 for individuals or § 11 for corporations).

(B) *Applicable time-value rate.* The applicable time-value rate generally equals an average of the quarterly underpayment rates in effect under § 6621(a) for the applicable period. However, for a taxpayer that would be entitled to a deduction under § 163(a) for the specified amount if the specified amount were treated as interest arising from the underpayment of tax, the applicable time-value rate is computed at a reduced rate equaling an average of the quarterly underpayment rates in effect under § 6621(a) for the applicable period, multiplied by the excess of 100% over the applicable tax rate for the taxable year of the underpayment (overpayment).

(C) *Applicable period.* The applicable period begins on the due date (without regard to extensions) of the return for the taxable year of the underpayment (overpayment) and ends on the date on which the specified amount is paid.

(D) *Processing of specified amount.* The Appeals Officer or government counsel resolving the issue should forward checks in payment of specified amounts to:

Internal Revenue Service
201 W. Riverside Blvd
Manual Deposit Unit
Stop 31, Unit 21
Covington, KY 41019
Attn: Manager, Manual Deposit Unit.

The Manager of the Manual Deposit Unit should be notified by telephone, at (859) 292–5790, that the payment will be sent. The transmittal memorandum should state that the payment is a "Rev. Proc. 2002–18 Specified Amount" payment and should specify the name and TIN of the taxpayer, the type of taxpayer (LMSB, SBSE, W&I), and the year(s) to which the payment pertains.

SECTION 7. PROCEDURES FOR A SERVICE-IMPOSED ACCOUNTING METHOD CHANGE.

.01 *Requirement to Provide Notice to Taxpayer.*

(1) *In general.* An examining agent, appeals officer, or counsel for the government changing a taxpayer's method of accounting will provide notice that an accounting method issue is being treated as an accounting method change. However, an appeals officer or counsel for the government resolving an accounting method issue as an accounting method change is not required to provide notice that the accounting method issue is being treated as an accounting method change if such notice has been provided by the examining agent. In addition, if the examining agent has provided notice that an accounting method issue is being treated as an accounting method change and an appeals officer or counsel for the government subsequently resolves such accounting method issue on a nonaccounting-method-change basis, the appeals officer or counsel for the government should provide notice that the accounting method issue has not been treated as an accounting method change.

(2) *Form of notice.* The notice must be in writing. If the taxpayer and the Service execute a closing agreement finalizing the change, the notice will be provided in the closing agreement. If the taxpayer and the Service do not execute a closing agreement, the notice ordinarily will be provided in the examiner's report or the Form 870AD (Offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax and of Acceptance of Overpayment). However, the Service may also provide the notice in a preliminary notice of deficiency, a statutory notice of deficiency, a notice of claim disallowance, a notice of final administrative adjustment, a pleading (for example, a petition, complaint, or answer) or amendment thereto, or in any other similar writing provided to the taxpayer.

(3) *Content of notice.* The notice must include:

(a) a statement that the accounting method issue is being treated as an accounting method change or a clearly labeled § 481(a) adjustment; and

(b) a description of the new method of accounting.

(4) *Method not established without notice.* The resolution of an accounting method issue will not establish a new method of accounting if the Service does not provide the notice required by section 7.01 of this revenue procedure. See section 9 of this revenue procedure for the procedures applicable if the Service does not provide this notice.

.02 *Finalizing a Service-imposed Method Change.*

(1) *In general.* To implement a Service-imposed change in method of accounting, the taxpayer and the Service should execute a closing agreement under § 7121 in which the taxpayer agrees to the change and the terms and conditions of the change. For purposes of this revenue procedure, in the case of accounting method issues before a federal court, the term "closing agreement" includes any other appropriate settlement agreement. If the taxpayer and the Service execute such a closing agreement, then the change is final as of the date of the agreement (unless otherwise provided by a federal court). In the absence of such an agreement, a Service-imposed accounting method change is final only upon the expiration of the period of limitations for filing a claim for refund under § 6511 for the year of change or the date of a final court order requiring the change.

(2) *Content of closing agreement.* A closing agreement finalizing a Service-imposed accounting method change must comply with the requirements of Rev. Proc. 68–16 (1968–1 C.B. 770), and should include the information outlined in the Model Closing Agreement for Settlement on an Accounting Method Basis attached as APPENDIX A of this revenue procedure. A settlement agreement finalizing a Service-imposed accounting method change with respect to an accounting method issue that is pending before a federal court must conform to the rules and procedures of the court and should include the information outlined in the Model Closing Agreement for Settlement on an Accounting Method Change Basis attached as APPENDIX A of this revenue procedure.

.03 *Implementing a Service-imposed Method Change.*

(1) *Years before the Service.* The Service should make the adjustments necessary to effect a Service-imposed accounting method change to the taxpayer's returns for the taxable years under examination, before Appeals, or before a federal court. These adjustments include the adjustments to taxable income necessary to reflect the new method (including the § 481(a) adjustment required as a result of the change), and any collateral adjustments to taxable income or tax liability resulting from the change.

(2) *Succeeding years for which returns have been filed.* If a Service-imposed accounting method change is finalized by a closing agreement, the Service may require that the taxpayer file amended returns to reflect the change for any affected succeeding taxable years for which a federal income tax return has been filed as of the date of the agreement. The amended returns must include the adjustments to taxable income and any collateral adjustments to taxable income or tax liability resulting from the change necessary to reflect the new method. The Service may require that the amended returns be filed prior to execution of the closing agreement finalizing the change. If the Service does not require the amended returns, the taxpayer should file such amended returns. If the Service does not require the amended returns and the taxpayer does not file the amended returns, the Service should make the adjustments necessary to reflect the change for affected succeeding taxable years if and when it examines the returns for those years. A taxpayer that files an amended return using the new method prior to the date a Service-imposed change becomes final must continue to use the new method on all subsequent returns, unless the taxpayer obtains the consent of the Commissioner to change from the new method or the Service changes the taxpayer from the new method on subsequent examination. *See* Rev. Rul. 90–38. A taxpayer eligible to

file a "qualified amended return" under Rev. Proc. 94–69 (1994–2 C.B. 804) may satisfy any requirement to file an amended return by filing a "qualified amended return" in accordance with that revenue procedure.

(3) *Future years.* The taxpayer must use the new method of accounting on all returns filed after the date that a Service-imposed accounting method change becomes final (*see* section 7.02 of this revenue procedure), unless the taxpayer obtains the consent of the Commissioner to change from the new method or the Service changes the taxpayer from the new method on subsequent examination. A taxpayer that files a return using the new method prior to the date a Service-imposed change becomes final must continue to use the new method on all subsequent returns, unless the taxpayer obtains the consent of the Commissioner to change from the new method or the Service changes the taxpayer from the new method on subsequent examination. If the taxpayer does not use the new method on any return filed prior to the date a Service-imposed change becomes final, and does not file amended returns to reflect the change, the Service should make the adjustments necessary to reflect the change for the affected taxable years if and when it examines those returns.

.04 *Effect of Final Service-imposed Method Change.*

(1) *New method established.* A Service-imposed change that is final establishes a new method of accounting within the meaning of § 446(e) and § 1.446–1(e). As a result, the taxpayer is required to use the new method of accounting for the year of change and for all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change from the new method or the Service changes the taxpayer from the new method on subsequent examination.

(2) *Subsequent examination.* Except as provided in section 7.04(3) of this revenue procedure, the Service is not precluded from changing the taxpayer from the new method of accounting if the Service determines that the new method does not clearly reflect the taxpayer's income.

(3) *Audit protection.*

(a) *In general.* A taxpayer that executes a closing agreement finalizing a Service-imposed accounting method change will not be required to change or modify the new method for any taxable year for which a federal income tax return has been filed as of the date of the closing agreement, provided that:

(i) the taxpayer has complied with all the applicable provisions of the closing agreement;

(ii) there has been no taxpayer fraud, malfeasance, or misrepresentation of a material fact;

(iii) there has been no change in the material facts on which the closing agreement was based; and

(iv) there has been no change in the applicable law on which the closing agreement was based.

(b) *Limitations.* The Service may require the taxpayer to change or modify the new method in the earliest open taxable year if the taxpayer fails to comply with the applicable provisions of the agreement or upon a showing of the taxpayer's fraud, malfeasance, or misrepresentation of a material fact. The Service may require the taxpayer to change or modify the new method in the earliest open taxable year in which the material facts have changed. The Service also may require the taxpayer to change or modify the new method in the earliest open taxable year in which the applicable law has changed. For this purpose, a change in the applicable law includes: (i) the enactment of legislation; (ii) a decision of the United States Supreme Court; (iii) the issuance of temporary or final regulations; or (iv) the issuance of a revenue ruling, revenue procedure, notice, or other guidance published in the Internal Revenue Bulletin.

.05 *Coordination with Examination.* An appeals officer or counsel for the government changing a taxpayer's method of accounting will coordinate the resolution with Examination if the appeals officer or counsel for the government proposes to defer the year of change to any taxable year not before appeals or a federal court. Examination will advise the appeals officer or counsel for the government of any changes in material fact in any taxable year under examination.

.06 *Deemed Cut-off Method.* If the Service does not impose a § 481(a) adjustment but otherwise provides the notice required by section 7.01 of this revenue procedure, the Service-imposed change will be treated as being made using a cut-off method, unless the Service and the taxpayer specifically have agreed in writing to compromise the amount of the § 481(a) adjustment.

SECTION 8. PROCEDURES FOR RESOLVING ACCOUNTING METHOD ISSUES ON A NONACCOUNTING-METHOD-CHANGE BASIS

.01 *Closing agreement required.* To resolve an accounting method issue raised by the Service on a nonaccounting-method-change basis, the Service and the taxpayer will execute a closing agreement under § 7121. For purposes of this revenue procedure, in the case of accounting method issues before a federal court, the term "closing agreement" includes any other appropriate settlement agreement. If the accounting method issue is being resolved on an alternative-timing basis as described in section 6.02(3) of this revenue procedure, the taxpayer must agree to pay the government any taxes and interest due as a result of the resolution. If the accounting method issue is being resolved on a time-value-of-money basis as described in section 6.02(4) of this revenue procedure, the taxpayer must agree to pay the government the specified amount as a result of the resolution.

.02 *Content of Closing Agreement.* A closing agreement finalizing the resolution of an accounting method issue on a nonaccounting-method-change basis must comply with the requirements of Rev. Proc. 68–16, and should include the information outlined in the Model Closing Agreement for Settlement on a Nonaccounting-method-change Basis attached as APPENDIX B of this revenue procedure. A closing agreement resolving an accounting method issue that is pending before a federal court on a nonaccounting-method-basis must conform to the rules and procedures of the court and should include the information outlined in the Model Closing Agreement for Settlement on a Nonaccounting-method-change Basis attached as APPENDIX B of this revenue procedure.

.03 *Implementing Resolution of an Accounting Method Issue on a Nonaccounting-method-change Basis.*

(1) *Resolution on an alternative-timing basis.*

(a) *Years before the Service.* The Service should make the adjustments necessary to effect an alternative-timing resolution for the taxable years before appeals or before a federal court. These adjustments include the adjustments to taxable income necessary to reflect the resolution and any collateral adjustments to taxable income or tax liability resulting from the resolution.

(b) *Succeeding years for which returns have been filed.* The Service may require that the taxpayer file amended returns to reflect an alternative-timing resolution for any affected succeeding taxable years for which a federal income tax return has been filed as of the date of the closing agreement. The amended returns must include the adjustments to taxable income and any collateral adjustments to taxable income or tax liability resulting from the resolution necessary to reflect the resolution. The Service may require that the amended returns be filed prior to execution of the closing agreement finalizing the resolution. If the Service does not require the amended returns, the taxpayer should file such amended returns. If the Service does not require amended returns and the taxpayer does not file amended returns, the Service should make the adjustments necessary to reflect the resolution for affected succeeding taxable years if and when it examines the returns for those years. A taxpayer eligible to file a "qualified amended return" under Rev. Proc. 94–69 may satisfy any requirement to file an amended return by filing a "qualified amended return" in accordance with that revenue procedure.

(c) *Future years.* The taxpayer must reflect the alternative-timing resolution on the returns for any affected succeeding taxable years for which a return has not been filed as of the date of the closing agreement. The taxpayer must continue to file its returns on its current method of accounting for all items not covered by the closing agreement, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination.

(2) *Resolution on a time-value-of-money basis.* The taxpayer must pay the specified amount required by the time-value-of-money resolution. The Service will not change or otherwise propose adjustments to taxable income with respect to the taxpayer's method of accounting for the taxable years covered by a closing agreement. The taxpayer must continue to file its returns on its current method of accounting, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination.

.04 *Effect of Resolving an Accounting Method Issue on a Nonaccounting-method-change Basis.*

(1) *No change in method.* If the Service resolves an accounting method issue on a nonaccounting-method-change basis, the resolution does not constitute a change in method of accounting. If the accounting method issue is resolved on an alternative-timing basis, the taxpayer is required to use its current method of accounting for all items not covered by the closing agreement, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination. If the accounting method issue is resolved on a time-value-of-money basis, the taxpayer is required to continue to use its current method of accounting on all returns for taxable years subsequent to the years covered by the closing agreement, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination.

(2) *Subsequent change.*

(a) *Resolution on an alternative-timing basis.* If an accounting method issue is resolved on an alternative-timing basis, the Service is not precluded from changing the taxpayer's method of accounting in any open taxable year for any item not covered by the closing agreement.

(b) *Resolution on a time-value-of-money basis.* If an accounting method issue is resolved on a time-value-of-money basis, the Service is not precluded from changing the taxpayer's method of accounting in any open taxable year not covered by the closing agreement.

(3) *Effect of subsequent change.*

(a) *Resolution on an alternative-timing basis.* If an accounting method issue is resolved on an alternative-timing basis and the taxpayer's method of accounting subsequently is changed (voluntarily or involuntarily) in any open taxable year, the § 481(a) adjustment (if any) will be determined by reference to all items arising prior to the year of change, except those items covered by the closing agreement (that is, those items for which the closing agreement specifically provides the manner in which the items are to be accounted for).

(b) *Resolution on a time-value-of-money basis.* If an accounting method issue is resolved on a time-value-of-money basis and the taxpayer's method of accounting subsequently is changed (voluntarily or involuntarily) in any open taxable year not covered by the closing agreement, the § 481(a) adjustment (if any) will be determined by reference to all items arising prior to the year of change. If the Service subsequently changes the taxpayer's method of accounting and imposes a § 481(a) adjustment, the interest that is assessed on any underpayment, or the interest that is due on any overpayment, for the year of change will be treated as paid to the extent necessary to prevent duplicate payment of the time-value-of-money benefit relating to the § 481(a) adjustment.

SECTION 9. DEFAULT PROCEDURES

.01 *In General.* Section 9 of this revenue procedure applies to the resolution of any accounting method issue if the Service changes the taxpayer's method of accounting and fails to provide the notice required by section 7.01 of this revenue procedure, or if the Service resolves the accounting method issue on a nonaccounting-method-change basis and the Service and the taxpayer do not execute a closing agreement as required by section 8.01 of this revenue procedure. See section 10.05 of this revenue procedure for an example of the application of section 9 of this revenue procedure.

.02 *Effect of Adjustments.* For accounting method issues resolved under section 9 of this revenue procedure:

(1) *No omission or duplication.* The Service and the taxpayer are required to treat all items in a manner that prevents

the duplication or omission of items of income or deduction;

(2) *No change in method.* The resolution does not constitute a change in method of accounting. The taxpayer is required to continue to use its current method of accounting for all items not affected by the adjustments made by the Service, unless the taxpayer obtains the consent of the Commissioner to change from its current method or the Service changes the taxpayer from its current method on subsequent examination;

(3) *Subsequent change.* The Service is not precluded from changing the taxpayer's method of accounting in any open taxable year; and

(4) *Effect of subsequent change.* If the taxpayer's method of accounting subsequently is changed (voluntarily or involuntarily) in any open taxable year, the § 481(a) adjustment (if any) will be determined by reference to all items arising prior to the year of change, including the items affected by the adjustment made by the Service.

SECTION 10. EXAMPLES.

The following examples illustrate how the provisions of this revenue procedure apply to the resolution of accounting method issues in various circumstances. These examples include explanations of the resolution of an accounting method issue previously resolved by Appeals on a nonaccounting-method-change basis in the event that Examination resolves such issue in a subsequent taxable year by changing the taxpayer's method of accounting. Note, however, that where the resolution of an accounting method issue is imposed by Appeals, an examining agent addressing such issue in a subsequent taxable year may resolve it consistently with the prior resolution by Appeals (*see* Delegation Order 236).

.01 *Examination-imposed Change.*

(1) *Facts.* A taxpayer that is a corporation deducted costs that the Service determines should have been capitalized to real property that was placed in service in 2000. The taxpayer incurred and deducted $1,000,000 of the costs in 1996, $2,000,000 in each of 1997 and 1998, and $5,000,000 in each of 1999 and 2000. The taxpayer is examined for the 1997 and 1998 taxable years (1997 is the earliest open year). The examining agent determines that the treatment of the costs is an accounting method issue, and that the taxpayer's deduction of the costs is an impermissible method of accounting. The examining agent therefore proposes an adjustment.

(2) *Effect.* Under section 5 of this revenue procedure, the examining agent is required to properly apply the law to the facts and change the taxpayer to the capitalization method of accounting for the costs. The examining agent imposes the change in 1997, the earliest open taxable year. The examining agent will provide the notice required by section 7.01 of this revenue procedure. The examining agent imposes a § 481(a) adjustment of $1,000,000 (representing the $1,000,000 of the costs deducted in 1996), the entire amount of which will be taken into account in computing taxable income in 1997. The examining agent also disallows the deductions of $2,000,000 in each of 1997 and 1998. The taxpayer's basis in the property as of the beginning of 1998 is increased by $5,000,000 (representing the $1,000,000 § 481(a) adjustment and the disallowance of the $2,000,000 of deductions in each of 1997 and 1998). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

.02 *Appeals Resolution of Accounting Method Issue as a Method Change With Compromise Terms and Conditions.*

(1) *Facts.* The facts are the same as in section 10.01 of this revenue procedure, except that the issue of whether the costs should be capitalized is referred to Appeals. The appeals officer believes that hazards of litigation exist with respect to the Service's position. The appeals officer and the taxpayer agree to resolve the accounting method issue by changing the taxpayer's method of accounting for the costs, but with compromise terms and conditions to reflect the hazards of litigation.

(2) *Effect.* Under section 6.02(2) of this revenue procedure, when the appeals officer changes the taxpayer's method of accounting, the appeals officer is required to properly apply the law to the facts and change the taxpayer to the capitalization method of accounting for the costs. The appeals officer should provide the notice required by section 7.01 of this revenue procedure.

The appeals officer may make the change using the cut-off method. If the appeals officer makes the change in 1997 using the cut-off method, the appeals officer will disallow the deductions of $2,000,000 in each of 1997 and 1998. The taxpayer's basis in the property as of the beginning of 1998 will be increased by $4,000,000 (representing the disallowance of the $2,000,000 of deductions in each of 1997 and 1998). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

Alternatively, the appeals officer may compromise the amount of the § 481(a) adjustment. If the appeals officer makes the change in 1997 and agrees to reduce the § 481(a) adjustment by 25%, the appeals officer will impose a § 481(a) adjustment of $750,000 (representing 75% of the amount of the costs deducted in 1996), the entire amount of which will be taken into account in computing taxable income in 1997. The appeals officer will disallow the deductions of $2,000,000 in each of 1997 and 1998. The taxpayer and the appeals officer agree in a closing agreement that basis in the property as of the beginning of 1998 will be increased by $4,750,000 (representing the reduced § 481(a) adjustment of $750,000 and the disallowance of the $2,000,000 of deductions in each of 1997 and 1998). The method change (once final) is effective for 1997. Thus, the taxpayer is required to capitalize the costs in 1997 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

As another alternative, the appeals officer may compromise the year of change and/or the § 481(a) adjustment period. For example, the appeals officer may agree to make the change in 1998 with a two-year § 481(a) adjustment

period. The appeals officer will impose a § 481(a) adjustment of $3,000,000 (representing the $1,000,000 of costs deducted in 1996 and the $2,000,000 of costs deducted in 1997), one-half of which will be taken into account in computing taxable income in each of 1998 and 1999. The appeals officer will disallow the deduction of $2,000,000 in 1998. The taxpayer's basis in the property as of the beginning of 1998 will be increased by $5,000,000 (representing the $3,000,000 § 481(a) adjustment and the disallowance of the $2,000,000 of deductions in 1998). The method change (once final) is effective for 1998. Thus, the taxpayer is required to capitalize the costs in 1998 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

.03 *Appeals Resolution of Accounting Method Issue on an Alternative-timing Basis.*

(1) *Facts.* The facts are the same as in section 10.02 of this revenue procedure, except that the appeals officer and the taxpayer agree to resolve the issue on an alternative-timing basis as described in section 6.02(3) of this revenue procedure and they enter into a closing agreement as required by section 8.01 of this revenue procedure. The accounting method issue is resolved by providing in the closing agreement that the taxpayer will deduct 50% of the costs incurred in 1997 and 1998 and capitalize the other 50% of the costs incurred in those years.

(2) *Effect.* The appeals officer will disallow $1,000,000 of the deductions in each of 1997 and 1998. The taxpayer's basis in the property as of the beginning of 1998 is increased by $2,000,000 (representing the disallowance of the $1,000,000 of deductions in each of 1997 and 1998). The taxpayer's current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs not covered by the agreement (that is, the costs incurred in 1996 and the costs incurred in 1999 and all subsequent taxable years), unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer's method in 1999, the Service will compute a § 481(a) adjustment of $1,000,000 (including the amount of the costs deducted in 1996, which are not covered by the agreement, and excluding the amount of those costs deducted in 1997 and 1998 because the costs are covered by the agreement). The Service will also disallow the deduction of $5,000,000 in 1999. The taxpayer's basis in the property as of the beginning of 1999 will be increased by an additional $6,000,000 (representing the $1,000,000 § 481(a) adjustment and the disallowance of the $5,000,000 deduction in 1999). The method change (once final) is effective for 1999. Thus, the taxpayer is required to capitalize the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

Alternatively, the accounting method issue may be resolved by providing in the closing agreement that the taxpayer will capitalize $1,000,000 of the costs incurred in each of 1997 and 1998 (and the agreement is silent as to the manner in which the other $1,000,000 of costs incurred in each of 1997 and 1998 are to be accounted for). The results for 1997 and 1998 will be the same as under the closing agreement in the original facts described in section 10.03(1) of this revenue procedure. That is, the appeals officer will disallow $1,000,000 of the deduction in each of 1997 and 1998. The taxpayer's basis in the property as of the beginning of 1998 is increased by $2,000,000 (representing the disallowance of the $1,000,000 of deductions in each of 1997 and 1998). Because the taxpayer's current method of accounting for the costs is not changed, the taxpayer is required to continue to deduct the costs not covered by the closing agreement (that is, the costs incurred in 1996, the remaining $1,000,000 of costs incurred in each of 1997 and 1998, and the costs incurred in 1999 and all subsequent taxable years). However, if the Service changes the taxpayer's method in 1999, the Service will compute a § 481(a) adjustment of $3,000,000 (including the $1,000,000 of the costs deducted in 1996 and the remaining $2,000,000 of the costs deducted in 1997 and 1998, because those costs are not items covered by the closing agreement). The Service also will disallow the deduction of $5,000,000 in 1999. The taxpayer's basis in the property as of the beginning of 1999 will be increased by an additional $8,000,000 (representing the $3,000,000 § 481(a) adjustment and the disallowance of the $5,000,000 deduction in 1999). The method change (once final) is effective for 1999. Thus, the taxpayer is required to capitalize the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

Assuming, in the alternative, that the accounting method issue is resolved by providing in the closing agreement that, for the costs incurred in 1996 through 1998, the taxpayer will deduct 50% of the costs and capitalize the other 50% of the costs, and will increase taxable income by $500,000 in 1997 (representing the disallowance of $500,000 of costs in 1996). The appeals officer will disallow $1,000,000 of the deductions in each of 1997 and 1998. The taxpayer's basis in the property as of the beginning of 1998 is increased by $2,500,000 (representing the disallowance of the $500,000 of deductions in 1996 and the $1,000,000 of deductions in each of 1997 and 1998). The taxpayer's current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs not covered by the closing agreement (that is, the costs incurred in 1999 and all subsequent taxable years), unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer's method in 1999, the Service will compute a § 481(a) adjustment of $0 (excluding the amount of the costs deducted in 1996 through 1998, because the manner in which those costs are to be accounted for is specifically covered by the closing agreement). The Service also will disallow the deduction of $5,000,000 in 1999. The taxpayer's basis in the property as of the beginning of 1999 will be increased by an additional $5,000,000 (representing the disallowance of the $5,000,000 deduction in 1999). The

method change (once final) is effective for 1999. Thus, the taxpayer is required to capitalize the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

.04 *Appeals Resolution of Accounting Method Issue on Time-value-of-money Basis.*

(1) *Facts.* The facts are the same as section 10.02 of this revenue procedure, except that the appeals officer and the taxpayer agree to settle the issue on a time-value-of-money basis as described in section 6.02(4) of this revenue procedure. The taxpayer files its return on a calendar year basis. The appeals officer and the taxpayer agree to compute the specified amount using the sample computation described in section 6.02(4)(b)(ii) of the revenue procedure. The appeals officer believes that an appropriate factor to reflect the hazards of litigation is 25%. The taxpayer pays the specified amount on May 15, 2000. The highest marginal tax rate applicable to the taxpayer for 1997 and 1998 is 35% and the quarterly large corporation underpayment rates in effect for January 1, 1998, through June 30, 2000, are: 11%, 10%, 10%, 10%, 9%, 10%, 10%, 10%, 10%, and 11%. The specified amount under section 6.02(4) of this revenue procedure would be deductible under § 163(a) by the taxpayer if it were treated as interest expense arising from an underpayment of tax.

(2) *Computation of specified amount.* The hypothetical underpayment of tax for 1997 is $1,050,000, computed as follows: the net increase in taxable income of $3,000,000 (representing the § 481(a) adjustment of $1,000,000 and the disallowance of the deduction of $2,000,000 computed as if Examination had changed the taxpayer's method in 1997) multiplied by the applicable tax rate of 35%. The hypothetical underpayment of tax for 1998 is $700,000, computed as follows: the net increase in taxable income of $2,000,000 (representing the disallowance of the deduction of $2,000,000 computed as if Examination had changed the taxpayer's method in 1997) multiplied by the applicable tax rate of 35%.

The applicable time-value rate for 1997 is 6.565%, which is computed as follows: The applicable period for 1997 is March 15, 1998 (the due date of the return) to May 15, 2000 (the date the specified amount is paid). The underpayment rates in effect for the applicable period are 11%, 10%, 10%, 10%, 9%, 10%, 10%, 10%, 10%, and 11%. The average underpayment rate in effect for the applicable period is 10.1% [(11+10+10+10+9+10+10+10+10+11)/10]. The applicable after-tax time-value rate is 6.565%, computed by multiplying the average underpayment rate by one minus the applicable tax rate [10.1% * (1-.35)].

The applicable time-value rate for 1998 is 6.5%, which is computed as follows: The applicable period for 1998 is March 15, 1999 (the due date of the return) to May 15, 2000 (the date the specified amount is paid). The underpayment rates in effect for the applicable period are 9%, 10%, 10%, 10%, 10%, and 11%. The average underpayment rate in effect for the applicable period is 10.00% [(9+10+10+10+10+11)/6]. The applicable after-tax time-value rate is 6.5%, computed by multiplying the average underpayment rate by one minus the applicable tax rate [10.00% * (1-.35)].

The time-value-of-money benefit for each taxable year is computed by using the following formula:

$U * \{[1+(r/365)]^n-1\}$

where U = hypothetical underpayment for the taxable year

r = the applicable time-value rate

n = the number of days in the applicable period

The time-value-of-money benefit for 1997 is $160,519, computed as follows: $\$1,050,000 * \{[1+(.06565/365)]^{791}-1$. The time-value-of-money benefit for 1998 is $55,165, computed as follows: $\$700,000 * [1+(.065/365)]^{426} -1\{ \}$.

The specified amount is the sum of the time-value-of-money benefit for 1997 and 1998 reduced by 25% to reflect the hazards of litigation. The specified amount is $161,763 computed as follows: ($160,519+$55,165)*(1-.25).

(3) *Effect.* The Service will not propose any adjustments to taxable income with respect to the taxpayer's method of accounting for the costs for 1997 and 1998. The taxpayer's basis in the property as of the beginning of 1998 is not changed. The taxpayer's current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer's method in 1999, the Service will compute a § 481(a) adjustment of $5,000,000 (representing the $1,000,000 of the costs deducted in 1996 and the $2,000,000 of costs deducted in each of 1997 and 1998). The Service will also disallow the deduction of $5,000,000 in 1999. The taxpayer's basis in the property as of the beginning of 1999 will be increased by $10,000,000 (representing the $5,000,000 § 481(a) adjustment and the disallowance of the $5,000,000 deduction in 1999). The method change (once final) is effective for 1999. Thus, the taxpayer is required to capitalize the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

The interest on the taxpayer's deficiency (which reflects the inclusion of the $5,000,000 § 481(a) adjustment in taxable income) for 1999 is $100,000. A portion of the $100,000 of interest will be treated as paid to the extent necessary to prevent duplicate payment of the time-value-of-money benefit relating to the § 481(a) adjustment. The interest on the deficiency for 1999 includes the time-value-of-money benefit attributable to the § 481(a) adjustment for the period March 15, 2000, through the date of payment of the deficiency. The taxpayer previously paid the Service the time-value-of-money benefit attributable to $3,000,000 of the § 481(a) adjustment for the period March 15, 1998, through May 15, 2000, and $2,000,000 of disallowed deduction for the period March 15, 1999, through May 15, 2000. The interest on the deficiency for 1999 attributable to the overlap period of March 15, 2000, through May 15, 2000, is $19,112, computed as follows:

$A * t * \{[1+(r/365)]^n-1\}$

where A = the § 481(a) adjustment

t = highest marginal tax rate applicable to the taxpayer

r = the applicable time-value rate (computed for the overlap period)

n = the number of days in the overlap period

$\$5,000,000 * .35 * \{[1+(.065/365)]^{61}-1\}$

The $19,112 is reduced by 25% (the factor used by the appeals officer to reflect the hazards of litigation) to arrive at the interest credit of $14,334. The Service will treat the $14,334 as a payment toward the $100,000 of interest on the taxpayer's deficiency for 1999.

.05 *Default Procedures.*

(1) *Facts.* The facts are the same as section 10.01 of this revenue procedure, except that the examining agent does not provide the notice required by section 7.01 of this revenue procedure. Specifically, the examining agent disallows the deductions of $2,000,000 in each of 1997 and 1998, but does not compute the § 481(a) adjustment of $1,000,000 or otherwise provide notice that the accounting method issue is being treated as an accounting method change.

(2) *Effect.* The taxpayer's basis in the property as of the beginning of 1998 is increased by $4,000,000 (representing the disallowance of the $2,000,000 of deductions in each of 1997 and 1998). The taxpayer's current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer's method in 1999, the Service will compute a § 481(a) adjustment of $1,000,000 (representing the $1,000,000 of the costs deducted in 1996). The Service will also disallow the deduction of $5,000,000 in 1999. The taxpayer's basis in the property as of the beginning of 1999 will be increased by an additional $6,000,000 (representing the $1,000,000 § 481(a) adjustment and the disallowance of the $5,000,000 deduction in 1999). The method change (once final) is effective for 1999. Thus, the taxpayer is required to capitalize the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

Assume that the examining agent disallows the deductions of $2,000,000 in each of 1997 and 1998 and computes the § 481(a) adjustment of $1,000,000, but does not label the § 481(a) adjustment or otherwise provide notice that the accounting method issue is being treated as an accounting method change. The taxpayer's basis in the property as of the beginning of 1998 is increased by $5,000,000 (representing the $1,000,000 adjustment and the disallowance of the $2,000,000 of deductions in each of 1997 and 1998). The taxpayer's current method of accounting for the costs is not changed. Thus, the taxpayer is required to continue to deduct the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination. If the Service changes the taxpayer's method in 1999, the Service will compute a § 481(a) adjustment of $0 (excluding the $1,000,000 of the costs deducted in 1998 and the $2,000,000 of the costs deducted in each of 1997 and 1998 because the costs were accounted for in the prior adjustments). The Service will also disallow the deduction of $5,000,000 in 1999. The taxpayer's basis in the property as of the beginning of 1999 will be increased by an additional $5,000,000 (representing the disallowance of the $5,000,000 deduction in 1999). The method change (once final) is effective for 1999. Thus, the taxpayer is required to capitalize the costs in 1999 and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner to change the method or the Service changes the taxpayer from the method on subsequent examination.

SECTION 11. EFFECTIVE DATE

.01 *In General.* Except as provided in section 11.02 of this revenue procedure, this revenue procedure is effective for:

(1) examiner's reports issued on or after July 1, 2002; and

(2) Forms 870AD and agreements executed on or after July 1, 2002 (regardless of when the underlying examiner's report was issued).

.02 *Transition Rule.* The Service and the taxpayer may agree to apply this revenue procedure to agreements executed on or after March 14, 2002.

DRAFTING INFORMATION

The principal author of this revenue procedure is Grant Anderson of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Anderson at (202) 622–4970 (not a toll-free call).

APPENDIX A

MODEL CLOSING AGREEMENT FOR SETTLEMENT ON ACCOUNTING METHOD CHANGE BASIS

Department of the Treasury Internal Revenue Service

Closing Agreement on Final Determination Covering Specific Matters

Under § 7121 of the Internal Revenue Code, [*Insert taxpayer's name, address, telephone number, and identifying number*] ("the taxpayer") and the Commissioner of Internal Revenue ("the Commissioner") make the following closing agreement:

WHEREAS:

1. The accounting method issue covered by this agreement is the taxpayer's method of accounting for [*identify subject: for example:* "credit sales"];

2. The taxable year(s) covered by this closing agreement are [*insert taxable year(s) covered by the agreement*];

3. The taxpayer and the Commissioner relied on the following facts and representations in making this closing agreement: [*insert any relevant facts*];

4. Under the taxpayer's present method of accounting for [*identify subject: for example*, "credit sales"], the taxpayer [*describe in detail the method of accounting being changed: for example*, "includes income from credit sales in gross income when payment is received"];

5. [*If applicable, insert:*] The taxpayer has filed an amended return(s) for the taxable year(s) ended [*insert applicable affected succeeding taxable year(s) for which a federal income tax return has been filed as of the date of the closing agreement*] to reflect the change in method of accounting for [*insert subject: for example*, "credit sales"] described in this closing agreement;

6. [*If applicable, insert:*] A stipulated decision has been entered by the [*insert name of federal court*] with respect to the taxable year(s) ended [*insert date(s)*] that reflects taxable income for such year(s) computed using the new method of accounting for [*insert subject: for example*, "credit sales"].

NOW IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes that:

1. The Service is changing the taxpayer's method of accounting for [*insert subject: for example*, "credit sales"] to the method of [*describe the method of accounting to which the taxpayer is being changed: for example*, "including income from credit sales in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (an accrual method)"];

2. The change in method of accounting for [*insert subject: for example*, "credit sales"] is to be effected for the taxable year ended [*insert date*] (the year of change);

3. [*Insert if applicable*] An adjustment to income is required under § 481(a) of the Internal Revenue Code in the amount of $ [*insert amount in numbers*] ([*insert amount in words*] dollars), [*if applicable, insert* computed by taking into account the limitations under § 481(b),] as of the beginning of the year of change ([*insert date*]), for [*describe the adjustment: for example*, "credit sales"], which amount previously has not been included in the taxpayer's gross income. [*Alternatively, insert*] The change in method of accounting for [*insert subject: for example*, "credit sales"] is to made on a cut-off basis;

4. [*Insert if applicable*] The § 481(a) adjustment will be taken into account [*insert § 481(a) adjustment spread period: for example*, "entirely in the year of change."]

5. [*Insert if applicable*] The adjustment(s) to tax attributable to the adjustment(s) to taxable income resulting from the change in the method of accounting for [*insert subject: for example*, "credit sales"] (including the § 481(a) adjustment, current year adjustment(s), and any collateral adjustments to taxable income or tax liability resulting fom the change) for each taxable year covered by the closing agreement are as follows: [*insert the adjustments to each taxable year covered by the closing agreement in table form*], and;

6. The change in method of accounting for [*insert subject: for example*, "credit sales"] is a change in method of accounting within the meaning of Rev. Proc. 2002–18. As such, the provisions of section 446 of the Code, and the regulations thereunder, apply to the new method of accounting for [*insert subject: for example*, "credit sales."];

7. The Service is not precluded from changing the taxpayer's method of accounting for [*insert subject: for example*, "credit sales"] from the new method of accounting if the Service determines that the new method does not clearly reflect the taxpayer's income. However, under section 7.04(3) of Rev. Proc. 2002–18, the Service will not require the taxpayer to change its method of accounting for [*insert subject: for example*, "credit sales"] from the new method for [*insert taxable year(s) for which a federal income tax return has been filed as of the date of this closing agreement*], provided that:

(a) the taxpayer has complied with all the applicable provisions of this closing agreement;

(b) there has been no taxpayer fraud, malfeasance, or misrepresentation of a material fact;
(c) there has been no change in the material facts on which this closing agreement was based; and
(d) there has been no change in the applicable law on which this closing agreement was based;

8. [*Insert if applicable:*] The following additional conditions also apply: [*insert, for example, conditions with respect to waiving restrictions on assessment and collection, paying any tax, abating any overassessment, or refunding or crediting any tax overpayment*];

9. The taxpayer accepts this settlement and agrees to the applicable terms of Rev. Proc. 2002–18.
This agreement is final and conclusive except:

(1) The matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of a material fact;

(2) It is subject to the Internal Revenue Code sections that expressly provide that effect be given to their provisions (including any stated exception for § 7122) notwithstanding any law or rule of law; and

(3) If it relates to a tax period ending after the date of this agreement, it is subject to any law enacted after the agreement date, that applies to the tax period.

By signing, the parties certify that they have read and agreed to the terms of this document.

Your signature ______________________ **Date:** ______________

Spouse's signature if joint return: ______________________ **Date:** ______________

Taxpayer's representative: ______________________ Date: ______________
Taxpayer (other than an individual): ______________________ Date: ______________
Title: ______________________

Commissioner of Internal Revenue:
By:______________________ Date:______________
Title:______________________

Instructions

This agreement must be signed and filed in triplicate. (All copies must have original signatures.) The original and copies of the agreement must be identical. The name of the taxpayer must be stated accurately. The agreement may relate to one or more years.

If an attorney or agent signs the agreement for the taxpayer, the power of attorney (or a copy) authorizing that person to sign must be attached to the agreement.

If the taxpayer is a corporation, the agreement must be dated and signed with the name of the corporation, the signature and title of an authorized officer or officers, or the signature of an authorized attorney or agent. It is not necessary that a copy of an enabling corporate resolution be attached.

Use additional pages if necessary and identify them as part of this agreement.

Please see Rev. Proc. 68–16 (1968–1 C.B. 770) for a detailed description of practices and procedures applicable to most closing agreements.

APPENDIX B
MODEL CLOSING AGREEMENT FOR SETTLEMENT
ON NONACCOUNTING-METHOD-CHANGE BASIS

Department of the Treasury Internal Revenue Service

Closing Agreement on Final Determination Covering Specific Matters

Under § 7121 of the Internal Revenue Code, [*Insert taxpayer's name, address, telephone number, and identifying number*] ("the taxpayer") and the Commissioner of Internal Revenue ("the Commissioner") make the following closing agreement:

WHEREAS:

1. The accounting method issue covered by this closing agreement is [*identify subject: for example:* "costs of acquiring nondepreciable asset X"];

2. [*Insert if alternative-timing resolution*] The item(s) covered by this closing agreement are [*identify items subject to the closing agreement: for example*, "the costs incurred in connection with the acquisition of nondepreciable asset X in 1997 and 1998"]. [*Alternatively, insert if time-value-of-money resolution*] The taxable year(s) covered by this closing agreement are [*insert taxable year(s) covered by the agreement*];

3. The taxpayer and the Commissioner relied on the following facts and representations in making this closing agreement: [*insert any relevant facts*];

4. Under the taxpayer's present method of accounting for [*identify subject: for example*, "costs of acquiring nondepreciable asset X"], the taxpayer [*describe in detail the accounting method issue: for example*, "deducts the costs as an ordinary and necessary business expense"];

5. [*If applicable, insert:*] The taxpayer has filed an amended return(s) for the taxable year(s) ended [*insert applicable affected succeeding taxable years for which a federal income tax return has been filed as of the date of the closing agreement*] to reflect the alternative-timing resolution for [*insert subject: for example*, "costs of acquiring nondepreciable asset X"] described in this closing agreement;

6. [*If applicable, insert:*] A stipulated decision has been entered by the [*insert name of federal court*] with respect to the taxable years ended [*insert date(s)*] that reflects the nonaccounting-method-change resolution set forth in this agreement for [*insert subject: for example*, "costs of acquiring nondepreciable asset X"].

NOW IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes that:

1. The Service is not changing the taxpayer's method of accounting for [*insert subject: for example*, "costs of acquiring nondepreciable asset X"].

2. The accounting method issue covered by this agreement ([*identify subject: for example:* "costs of acquiring nondepreciable asset X"]) is being resolved on [*insert basis for resolution: for example*, "an alternative-timing basis" or "a time-value-of-money basis"].

[*If alternative-timing resolution, insert the following paragraphs 3 – 9 as applicable*]

3. The items covered by the closing agreement are to be accounted for in the affected taxable years as follows: [*insert a description of the manner in which the items are to be accounted for, for example*, "Fifty percent of the costs incurred in each of 1997 and 1998 ($1,000,000) will be deductible and the remaining fifty percent ($1,000,000) will be capitalized"];

4. As a result of this treatment, [*Insert a description of any collateral effects of thie alternative-timing treatment: for example*, "the taxpayer's basis in asset X is increased by $2,000,000"];

5. Any items not specifically covered by this closing agreement are not affected by this agreement;

6. The adjustment(s) to tax attributable to the adjustment to taxable income resulting from the resolution of [*insert subject: for example*, "costs of acquiring nondepreciable asset X"] by this agreement (including the current year adjustment and any collateral adjustments for each taxable year affected by this closing agreement) is [*insert taxable year(s)*], $ [*insert amount in numbers*] ([*insert amount in words*] dollars);

7. The Service is not precluded from changing the taxpayer's method of accounting for [*insert subject: for example*, "costs of acquiring nondepreciable asset X"] upon subsequent examination for any open taxable year for items not covered by this agreement;

8. If the taxpayer's method of accounting for [*insert subject: for example*, "costs of acquiring nondepreciable asset X"] subsequently is changed (voluntarily or involuntarily) in any open taxable year, the adjustment under § 481(a) (if any) will be determined by reference to all items arising prior to the year of change except for those items specifically covered by this closing agreement; and

9. [*Insert if applicable:*] The following additional conditions also apply: [*insert, for example, conditions with respect to waiving restrictions on assessment and collection, paying any tax, abating any overassessment, or refunding or crediting any tax overpayment*];

[*Alternatively, if a time-value-of-money resolution, insert the following paragraphs 3 – 10 as applicable*]

3. The computation of the specified amount as provided in section 6.02(4)(b) of Rev. Proc. 2002–18 has been made as follows: [*insert computation*].

4. The specified amount is not interest under § 163(a) of the Code and may not be deducted or capitalized under any provision of the Code.

5. [*Insert if the computation of the specified amount takes into account the taxpayer's actual tax attributes*] The tax attributes that may affect the computation of the taxpayer's tax liability in subsequent taxable years [*insert* "are" *or* "are not"] adjusted to reflect their effect on the specified amount;

6. The Service is not precluded from changing the taxpayer's method of accounting for [*insert subject: for example*, "costs of acquiring nondepreciable asset X"] upon subsequent examination for any open taxable year not covered by the agreement;

8. If the taxpayer's method of accounting for [*insert subject: for example*, "costs of acquiring nondepreciable asset X"] subsequently is changed (voluntarily or involuntarily) in any open taxable year not covered by this agreement, the adjustment under § 481(a) (if any) will be determined by reference to all items arising prior to the year of change;

9. If the Service changes the taxpayer's method of accounting in an open taxable year not covered by this agreement and imposes a § 481(a) adjustment, the interest that is assessed on any underpayment, or the interest that is due on any overpayment, for the year of change will be treated as paid to the extent necessary to prevent duplicate payment of the time-value-of-money benefit relating to the § 481(a) adjustment;

10. [*Insert if applicable:*] The following additional conditions also apply: [*insert, for example, conditions with respect to waiving restrictions on assessment and collection, paying any tax, abating any overassessment, or refunding or crediting any tax overpayment*];

The taxpayer accepts this settlement and agrees to the applicable terms of Rev. Proc. 2002–18.

This agreement is final and conclusive except:

(1) The matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of a material fact;

(2) It is subject to the Internal Revenue Code sections that expressly provide that effect be given to their provisions (including any stated exception for § 7122) notwithstanding any law or rule of law; and

(3) If it relates to a tax period ending after the date of this agreement, it is subject to any law enacted after the agreement date, that applies to the tax period.

By signing, the parties certify that they have read and agreed to the terms of this document.

Your signature____________________ Date:______________
Spouse's signature if joint return: ____________________ Date:______________
Taxpayer's representative: ____________________ Date:______________
Taxpayer (other than an individual): ____________________ Date:______________
Title:____________________

Commissioner of Internal Revenue:

By:____________________ Date:______________
Title:____________________

Instructions

This agreement must be signed and filed in triplicate. (All copies must have original signatures.) The original and copies of the agreement must be identical. The name of the taxpayer must be stated accurately. The agreement may relate to one or more years.

If an attorney or agent signs the agreement for the taxpayer, the power of attorney (or a copy) authorizing that person to sign must be attached to the agreement.

If the taxpayer is a corporation, the agreement must be dated and signed with the name of the corporation, the signature and title of an authorized officer or officers, or the signature of an authorized attorney or agent. It is not necessary that a copy of an enabling corporate resolution be attached.

Use additional pages if necessary and identify them as part of this agreement.

Please see Rev. Proc. 68–16 (1968–1 C.B. 770) for a detailed description of practices and procedures applicable to most closing agreements.

26 CFR 601.204: Changes in accounting periods and methods of accounting.
(Also Part I, §§ 446, 481; 1.446–1, 1.481–1, 1.481–4.)

Rev. Proc. 2002–19

SECTION 1. PURPOSE

This revenue procedure modifies Rev. Proc. 97–27 (1997–1 C.B. 680) which provides procedures under which taxpayers may obtain the advance consent of the Commissioner of Internal Revenue to change a method of accounting. In addition, this revenue procedure modifies Rev. Proc. 2002–9 (2002–3 I.R.B. 327) which provides procedures for taxpayers within the scope of that revenue procedure to obtain automatic consent to change a method of accounting.

The changes to Rev. Proc. 97–27 and Rev. Proc. 2002–9 include:

(1) allowing a taxpayer to change its method of accounting prospectively, without audit protection, if the method to be changed is an issue pending for a taxable year under examination or an issue under consideration by either an appeals office or a federal court;

(2) providing that, in the case of changes in method of accounting that result in a negative (*i.e.*, taxpayer-favorable) § 481(a) adjustment, the entire amount of the adjustment will be taken into account in the year of change; and

(3) certain other conforming and clarifying changes.

For a discussion of the policy reasons for certain of the modifications provided by this revenue procedure, see Announcement 2002–37 (2002–13 I.R.B. 703)

SECTION 2. CHANGES

.01 *Changes to BACKGROUND Sections.* Section 2.01(3) in each of Rev. Proc. 97–27 and Rev. Proc. 2002–9 is deleted.

.02 *Changes to § 481(a) Spread Period for Negative § 481(a) Adjustments.*

(1) Section 5.02(3)(a) of Rev. Proc. 97–27 is modified to read as follows:

"(a) *In general.* Except as otherwise provided in sections 5.02(3)(b) and 7.03 of this revenue procedure, the § 481(a) adjustment period is four taxable years for a net positive adjustment for an accounting method change, and one taxable year for a net negative adjustment for an accounting method change."

(2) Section 5.04(1) of Rev. Proc. 2002–9 is modified to read as follows:

"(1) *In general.* Except as otherwise provided in section 5.04(3) or the APPENDIX of this revenue procedure, the § 481(a) adjustment period is four taxable years for a net positive adjustment for an accounting method change, and one taxable year for a net negative adjustment for an accounting method change."

(3) The second sentence in both Example 1 and Example 2 in section 7.02 of Rev. Proc. 97–27 and section 5.04(2) of Rev. Proc. 2002–9 is modified to read as follows:

"The net § 481(a) adjustment for this method change is a positive adjustment of $30,000 and the adjustment period is four taxable years."

(4) Section 7.03(1) of Rev. Proc. 97–27 and section 5.04(3)(a) of Rev. Proc. 2002–9 are each modified to read as follows:

"*De minimis* rule. A taxpayer may elect to use a one-year adjustment period in lieu of the § 481(a) adjustment period otherwise provided by this revenue procedure for positive adjustments if the net § 481(a) adjustment for the change is less than $25,000. The taxpayer must complete the appropriate line on the Form 3115 to elect this *de minimis* rule."

(5) Section 4.01(3) of the APPENDIX of Rev. Proc. 2002–9 (relating to the § 481(a) adjustment for certain uniform capitalization methods used by resellers and reseller-producers) is modified to read as follows:

"(3) *Section 481(a) adjustment.* Beginning with the year of change, a taxpayer changing its method of accounting for costs pursuant to sections 4.01(a)(1)(i), 4.01(1)(a)(iii), or 4.01(1)(a)(iv) of this APPENDIX generally must take any applicable net positive § 481(a) adjustment for such change into account ratably over the same number of taxable years, not to exceed four, that the taxpayer used its former method of accounting. A taxpayer changing its method of accounting for costs pursuant to sections 4.01(1)(a)(ii), 4.01(1)(a)(v), or 4.01(1)(a)(vi) of this APPENDIX generally must take any applicable net positive § adjustment for such change into account ratably over four taxable years. See section 5.04(3) of this revenue procedure for exceptions to this general rule."

(6) Section 4.01(5) of the APPENDIX of Rev. Proc. 2002–9, which provides an example illustrating the change to and from a UNICAP method of accounting for small resellers and formerly small resellers is modified to read as follows:

"(5) *Example.*

* * *

Because X satisfies the small reseller exception for 1997, X may change voluntarily from the UNICAP method to a permissible non-UNICAP inventory capitalization method under section 4.01 of this APPENDIX. To reflect the removal of the additional § 263A costs from the cost of its 1997 beginning inventory, X must compute a corresponding § 481(a) adjustment, which is a negative $100,000 ($1,200,000 - $1,300,000). The entire amount of this negative § 481(a) adjustment is included in the computation of X's taxable income for 1997. In addition, X must include $20,000 of the unamortized 1995 § 481(a) adjustment in 1997 taxable income.

X's 1997 Ending Inventory:	
Beginning Inventory (With UNICAP costs)	$1,300,000
1997 Increment	100,000
1997 § 481(a) Adjustment <Negative>	<100,000>
Total 1997 Ending Inventory	$1,300,000

X's Unamortized 1995 § 481(a) Adjustment:

Unamortized 1995 § 481(a) Adjustment—12/31/96	$40,000
Amount Included in 1997 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/97	$20,000

X's Unamortized 1997 § 481(a) Adjustment:

1997 § 481(a) Adjustment <Negative>	$<100,000>
Amount Included in 1997 Taxable Income	100,000
Unamortized 1997 § 481(a) Adjustment—12/31/97	$ 0

X also satisfies the small reseller exception for 1998 and, therefore, is not required to return to the UNICAP method for 1998. X, however, must include $20,000 of the unamortized 1995 positive § 481(a) adjustment in its 1998 taxable income.

X's 1998 Ending Inventory:

Beginning Inventory (Without UNICAP costs)	$1,300,000
1998 Increment	100,000
Total 1998 Ending Inventory	$1,400,000

X's Unamortized 1995 § 481(a) Adjustment:

Unamortized 1995 § 481(a) Adjustment—12/31/97	$20,000
Amount Included in 1998 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/98	$ 0

In 1999, X fails to satisfy the small reseller exception and, therefore, must return to the UNICAP method as provided under section 4.01 of this APPENDIX. X changes to the simplified resale method without a historic absorption ratio election under § 1.263A–3(d)(3). Assume that X must capitalize $120,000 of additional § 263A costs to the cost of its 1999 beginning inventory because of this change in inventory method. Because X used a non-UNICAP for two taxable years prior to 1999, the § 481 spread period for the positive § 481(a) adjustment is two years. Therefore, X must include one-half of the § 481(a) adjustment ($60,000) when computing taxable income for 1999 and 2000. Assume that X must add $10,000 of additional § 263A costs to the cost of its 1999 ending inventory because of the $100,000 increment for 1999.

X's 1999 Ending Inventory:

Beginning Inventory (Without UNICAP costs)	$1,400,000
1999 Increment	100,000
Additional § 263A costs in Beginning Inventory	120,000
Additional § 263A costs in 1999 Increment	10,000
Total 1999 Ending Inventory	$1,630,000

X's Unamortized 1999 § 481(a) adjustment:

1999 § 481(a) Adjustment	$120,000
Amount Included in 1999 Taxable Income	<60,000>
Unamortized 1999 § 481(a) Adjustment—12/31/99	$60,000

Because X fails to satisfy the small reseller exception for 2000, X must continue using the UNICAP method for its inventory costs. Furthermore, X is required to include $60,000 of the unamortized 1999 positive § 481(a) adjustment in 2000 taxable income. Assume that X is required to add $10,000 of additional § 263A costs to the cost of its 2000 ending inventory because of the $100,000 increment for 2000.

X's 2000 Ending Inventory:

Beginning Inventory (With UNICAP costs)	$1,630,000
2000 Increment	100,000
Additional § 263A Costs in 2000 Increment	10,000
Total 2000 Ending Inventory	$1,740,000

X's Unamortized 1999 § 481(a) Adjustment:

Unamortized 1999 § 481(a) Adjustment—12/31/99	$60,000
Amount Included in 2000 Taxable Income	<60,000>
Unamortized 1999 § 481(a) Adjustment—12/31/00	$ 0

.03 *Changes to Scope Restrictions for Taxpayers Under Examination, or Before an Area Appeals Office or a Federal Court.*

(1) *Taxpayers under examination.*

(a) Section 4.02(2) of Rev. Proc. 97–27 (relating to the situations in which Rev. Proc. 97–27 does not apply) is modified to read as follows:

"(2) *Under examination.* If the taxpayer is under examination, except as provided in sections 6.01(2) (90-day window), 6.01(3) (120-day window), 6.01(4) (director consent), and 6.01(5) (issue pending) of this revenue procedure."

(b) Section 6.01 of Rev. Proc. 97–27 (relating to procedures for taxpayers under examination) is modified as follows:

"(1) *In general.* A taxpayer that is under examination may not file a Form 3115 to request a change in accounting method under this revenue procedure except as provided in sections 6.01(2) (90-day window), 6.01(3) (120-day window), 6.01(4) (director consent), and 6.01(5) (issue pending). A taxpayer that files a Form 3115 beyond the time periods provided in the 90-day and 120-day windows will not be granted an extension of time to file under § 301.9100, except in unusual and compelling circumstances."

* * *

"(5) *Issue Pending.* (a) A taxpayer that is under examination with respect to any income tax issue may request to change a method of accounting if the method of accounting to be changed is an issue pending for any taxable year under examination. However, the audit protection provisions of section 9.01 of this revenue procedure do not apply to a taxpayer changing its method of accounting under this section 6.01(5). For this purpose, an issue is pending for taxable years under examination if the Service has given the taxpayer written notification indicating an adjustment is being made or will be proposed with respect to the taxpayer's method of accounting. This notification normally will occur after the Service has gathered information sufficient to determine that an adjustment is appropriate and justified, although the exact amount of the adjustment may not yet be determined.

(b) A taxpayer that requests to change a method of accounting under this section 6.01(5) must provide a copy of the Form 3115 to the examining agent(s) at the same time it files the original Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s). In order to assist in processing an application under this section 6.01(5), the taxpayer should type or legibly write "Issue pending" on the Form 3115."

(c) Section 4.02(1) of Rev. Proc. 2002–9 (relating to situations in which Rev. Proc. 2002–9 does not apply) is modified to read as follows:

"(1) *Under examination.* If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is under examination (as provided in section 3.08 of this revenue procedure), except as provided in sections 6.03(2) (90-day window), 6.03(3) (120-day window), 6.03(4) (director consent), 6.03(5) (changes lacking audit protection), and 6.03(6) (issue pending) of this revenue procedure."

(d) Section 6.03 of Rev. Proc. 2002–9 (relating to procedures for taxpayers under examination) is modified as follows:

"(1) *In general.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, section 1.01 of the APPENDIX of this revenue procedure), a taxpayer that is under examination may file an application to change a method of accounting under section 6 of this revenue procedure only if the taxpayer is within the provisions of section 6.03(2) (90-day window), 6.03(3) (120-day window), 6.03(4) (director consent), 6.03(5) (changes lacking audit protection), or 6.03(6) (issue pending) of this revenue procedure. A taxpayer that files an application beyond the time periods provided in the 90-day and 120-day windows is not eligible for the automatic extension of time and will not be granted an extension of time to file under § 301.9100, except in unusual and compelling circumstances."

* * *

"(6) *Issue Pending*. (a) A taxpayer that is under examination with respect to any income tax issue may request to change a method of accounting if the method of accounting to be changed is an issue pending for any taxable year under examination. However, the audit protection provisions of section 7.01 of this revenue procedure do not apply to a taxpayer changing its method of accounting under this section 6.03(6). For this purpose, an issue is pending for taxable years under examination if the Service has given the taxpayer written notification indicating an adjustment is being made or will be proposed with respect to the taxpayer's method of accounting. This notification normally will occur after the Service has gathered information sufficient to determine that an adjustment is appropriate and justified, although the exact amount of the adjustment may not yet be determined.

(b) A taxpayer that requests to change a method of accounting under this section 6.03(6) must provide a copy of the Form 3115 to the examining agent(s) at the same time it files the original Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s). In order to assist in processing an application under this section 6.03(6), the taxpayer should type or legibly write "Issue pending" on the Form 3115."

(2) *Taxpayers before an appeals office*.

(a) Section 4.02(3) of Rev. Proc. 97–27 (relating to the situations in which Rev. Proc. 97–27 does not apply) is deleted.

(b) Section 6.02 of Rev. Proc. 97–27 (relating to procedures for taxpayers before an appeals office) is modified as follows:

".02 *Taxpayer before an appeals office*. A taxpayer otherwise within the scope of this revenue procedure that is before an appeals office with respect to any income tax issue may request a change in accounting method. However, the audit protection provisions of section 9.01 of this revenue procedure do not apply if the accounting method to be changed is an issue under consideration by the appeals office. A taxpayer that requests to change a method of accounting under this section 6.02 must provide a copy of the Form 3115 to the appeals officer at the time it files the original Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the appeals officer(s). In order to assist in processing an application under this section 6.02, the taxpayer should type or legibly write "Issue under consideration" on the Form 3115."

(c) Section 4.02(2) of Rev. Proc. 2002–9 (relating to situations to which Rev. Proc. 2002–9 does not apply) is deleted.

(d) Section 6.04 of Rev. Proc. 2002–9 (relating to procedures for taxpayers before an appeals office) is modified to read as follows:

".04 *Taxpayer before an appeals office*. A taxpayer otherwise within the scope of this revenue procedure that is before an appeals office with respect to any income tax issue may request a change in accounting method. However, the audit protection provisions of section 7.01 of this revenue procedure do not apply if the accounting method to be changed is an issue under consideration by the appeals office. A taxpayer that requests to change a method of accounting under this section 6.04 must provide a copy of the Form 3115 to the appeals officer at the time it files the original Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the appeals officer(s). In order to assist in processing an application under this section 6.04, the taxpayer should type or legibly write "Issue under consideration" on the Form 3115."

(3) *Taxpayers before a federal court*.

(a) Section 4.02(4) of Rev. Proc. 97–27 (relating to the situations in which Rev. Proc. 97–27 does not apply) is deleted.

(b) Section 6.03 of Rev. Proc. 97–27 (relating to procedures for taxpayers before a federal court) is modified to read as follows:

".03 *Taxpayer before a federal court*. A taxpayer otherwise within the scope of this revenue procedure that is before a federal court with respect to any income tax issue may request a chânge in accounting method. However, the audit protection provisions of section 9.01 of this revenue procedure do not apply if the accounting method to be changed is an issue under consideration by the federal court. A taxpayer that requests to change a method of accounting under this section 6.03 must provide a copy of the Form 3115 to the counsel(s) for the government at the time it files the original Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the counsel(s) for the government. In order to assist in processing an application under this section 6.03, the taxpayer should type or legibly write "Issue under consideration" on the Form 3115."

(c) Section 4.02(3) of Rev. Proc. 2002–9 (relating to situations to which Rev. Proc. 2002–9 does not apply) is deleted.

(d) Section 6.05 of Rev. Proc. 2002–9 (relating to procedures for taxpayers before a federal court) is modified to read as follows:

.05 *Taxpayer before a federal court*. A taxpayer otherwise within the scope of this revenue procedure that is before a federal court with respect to any income tax issue may request a change in accounting method. However, the audit protection provisions of section 7.01 of this revenue procedure do not apply if the accounting method to be changed is an issue under consideration by the federal court. A taxpayer that requests to change a method of accounting under this section 6.05 must provide a copy of the Form 3115 to the counsel(s) for the government at the time it files the original Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the counsel(s) for the government. In order to assist in processing an application under this section 6.05, the taxpayer should type or legibly write "Issue under consideration" on the Form 3115."

.04 *Notional Principal Contracts*. Section 14.02 of Rev. Proc. 97–27 (relating to Designated A treatment for changes in method of accounting for notional principal contracts) is deleted.

SECTION 3. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 97–27 and Rev. Proc. 2002–9 are modified and amplified.

SECTION 4. EFFECTIVE DATE

.01 *In General.* Except as otherwise provided in sections 4.02 and 4.03 of this revenue procedure, this revenue procedure is effective for taxable years ending on or after December 31, 2001.

.02 *Changes to Scope Restrictions of Rev. Proc. 97–27.* Notwithstanding section 4.01 of this revenue procedure, the changes to the scope restrictions of Rev. Proc. 97–27 provided in section 2.03(1)(a) and (b), 2.03(2)(a) and (b), and 2.03(3)(a) and (b) of this revenue procedure are effective for taxable years ending on or after March 14, 2002.

.03 *Notional Principal Contracts.* Notwithstanding section 4.01 of this revenue procedure, the deletion of section 14.02 of Rev. Proc. 97–27 is effective for Forms 3115 pending with the national office on March 14, 2002.

.04 *Transition Rules.*

(1) *Applications Under Rev. Proc. 2002–9.*

(a) If a taxpayer has filed its federal income tax return on or before April 15, 2002, for a taxable year ending on or after December 31, 2001, and wants to change a method of accounting for such taxable year under Rev. Proc. 2002–9 for an issue pending at examination, or an issue under consideration by an area office or by a federal court, without audit protection, as permitted under this revenue procedure, then the taxpayer must comply with the requirements of this section 4.04(1)(a). The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to the taxpayer's amended federal income tax return for the year of change. The amended return must be filed no later than September 10, 2002. A copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002–9 for the address) no later than when the taxpayer's amended return is filed.

(b) If a taxpayer has applied to change a method of accounting under Rev. Proc. 2002–9 for a taxable year ending on or after December 31, 2001, by filing an application with its federal income tax return on or before April 15, 2002, such change in method of accounting results in a net negative § 481(a) adjustment, and the taxpayer wants to apply the one-year § 481(a) adjustment period of this revenue procedure to the change, then the taxpayer must comply with the requirements of this section 4.04(1)(b). The taxpayer must complete and file a revised Form 3115 in duplicate, reflecting the one-year § 481(a) adjustment period. The original must be attached to the taxpayer's amended federal income tax return for the year of change. The amended return must be filed no later than September 10, 2002. A copy of the revised Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002–9 for the address) no later than when the taxpayer's amended return is filed. Both the original and the copy of the application filed with the national office should be labeled "Substitute Application under Rev. Proc. 2002–19."

(c) If a taxpayer has filed a copy of an application to change a method of accounting under Rev. Proc. 2002–9 for a taxable year ending on or after December 31, 2001, with the national office on or before April 15, 2002, but has not filed its federal income tax return with the original application attached by April 15, 2002, such change in method of accounting results in a net negative § 481(a) adjustment, and the taxpayer wants to apply the one-year § 481(a) adjustment period of this revenue procedure to the change, then the taxpayer must comply with the requirements of this section 4.04(1)(c). The taxpayer must complete and file a revised Form 3115 in duplicate, reflecting the one-year § 481(a) adjustment period. The revised original Form 3115 must be attached to the taxpayer's timely filed federal income tax return for the year of change. The revised copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002–9 for the address) no later than when the taxpayer's original federal income tax return is filed. The copy of the application filed with the national office should be labeled "Substitute Application under Rev. Proc. 2002–19."

(d) If a taxpayer has filed an original application and/or a copy of an application to change a method of accounting under Rev. Proc. 2002–9 for a taxable year ending on or after December 31, 2001, with the national office on or before April 15, 2002, such change in method of accounting results in a net negative § 481(a) adjustment, and the taxpayer does not file revised applications under either section 4.04(1)(b) or (c) of this revenue procedure (whichever applies), then the four-year § 481(a) adjustment period of Rev. Proc. 2002–9 (prior to its modification by this revenue procedure) will apply to the change.

(2) *Applications Under Rev. Proc. 97–27.* In the case of an application to change a method of accounting for a taxable year ending on or after December 31, 2001, filed under Rev. Proc. 97–27, and pending with the national office on March 14, 2002, the § 481(a) adjustment period for a net negative § 481(a) adjustment for the change will be one taxable year. In such a case, the national office will require the taxpayer to make appropriate modifications to the application or ruling request to comply with the applicable provisions of this revenue procedure. However, if such a taxpayer does not want a one-year § 481(a) adjustment period to apply, the taxpayer must notify the national office prior to the later of April 30, 2002, or the issuance of the letter ruling granting or denying consent to the change. In such a case, the § 481(a) adjustment period rules of Rev. Proc. 97–27, prior to its modification by this revenue procedure, will apply.

DRAFTING INFORMATION

The principal author of this revenue procedure is Grant D. Anderson of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information concerning this revenue procedure, please contact Mr. Anderson at (202) 622–4970 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Loss Limitation Rules

REG–102740–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: This document contains proposed regulations under sections 337(d) and 1502 of the Internal Revenue Code. These regulations permit certain losses recognized on sales of subsidiary stock by members of a consolidated group. The regulations apply to corporations filing consolidated returns, both during and after the period of affiliation, and also affect purchasers of the stock of members of a consolidated group. The text of the temporary regulations published in T.D. 8984, in this issue of the Bulletin also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 10, 2002. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for July 17, 2002, at 10 a.m., must be received by June 26, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–102740–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 6 p.m. to CC:ITA:RU (REG–102740–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the Internal Revenue Service Auditorium, in the Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sean P. Duffley (202) 622–7530, or Lola L. Johnson (202) 622–7550; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita VanDyke (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by May 6, 2002. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start up-costs and the costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §§ 1.337(d)–2T, 1.1502–20T, and 1.1502–32T. The collection of information is required to allow the taxpayer to make certain elections to determine the amount of allowable loss under § 1.337(d)–2T, § 1.1502–20 as currently in effect, or under § 1.1502–20 modified so that the amount of allowable loss determined pursuant to § 1.1502–20(c)(1) is computed by taking into account only the amounts computed under § 1.1502–20(c)(1)(i) and (ii); to allow the taxpayer to reapportion a section 382 limitation in certain cases; to allow the taxpayer to waive certain loss carryovers; and to ensure that loss is not disallowed under § 1.337(d)–2T and basis is not reduced under § 1.337(d)–2T to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain on the disposition of an asset. The collection of information is required to obtain a benefit. The likely respondents are corporations that file consolidated income tax returns.

Estimated total annual reporting burden: 30,000 hours.

Estimated average annual burden hours per respondent: 2 hours.

Estimated number of respondents: 15,000.

Estimated annual frequency of responses: once.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to the collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to sections 337(d) and 1502. The text of those regulations also serves as the text of these proposed regulations. The preamble to the

temporary regulations contains a full explanation of the reasons underlying the issuance of the proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses, and, moreover, that any burden on taxpayers is minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

The IRS and Treasury are undertaking a study of the various approaches that could be implemented to give full effect to section 337(d) and to reflect the single entity principles of the consolidated return rules. Among the approaches the IRS and Treasury are studying is one that would deny positive investment adjustments for gain recognized and income attributable to the disposition or consumption of built-in gain assets held by the subsidiary at the time it joined the consolidated group. In addition, the IRS and Treasury are considering allowing selling groups to deduct subsidiary stock losses that would otherwise reflect duplicated loss, if the subsidiary reduces its attributes (including net operating loss carryovers and asset basis) immediately prior to the disposition. Comments are requested concerning any approaches that may be employed to allow appropriate losses in a manner that is administrable for both taxpayers and the government.

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing has been scheduled for July 17, 2002, at 10 a.m., in the IRS Auditorium, IRS Building, 1111 Constitution, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

Drafting Information

The principal authors of these regulations are Sean P. Duffley and Lola L. Johnson, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.337(d)–2 is added to read as follows:

§ 1.337(d)–2 Loss limitation window period.

[The text of this proposed section is the same as the text of § 1.337(d)–2T published elsewhere in this issue of the **Federal Register**].

Par. 3. In § 1.1502–20, paragraph (i) is added to read as follows:

§ 1.1502–20 Disposition or deconsolidation of subsidiary stock.

[The text of this proposed section is the same as the text of § 1.1502–20T(i) published elsewhere in this issue of the **Federal Register**].

Par. 4. In § 1.1502–32, paragraph (b)(4)(v) is added to read as follows:

§ 1.1502–32 Investment adjustment.

[The text of this proposed section is the same as the text of § 1.1502–32T(b)(4)(v) published elsewhere in this issue of the **Federal Register**].

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 7, 2002, 3:17 p.m., and published in the issue of the Federal Register for March 12, 2002, 67 F.R. 11070)

Extension of Time to File Form(s) 1042–S

Announcement 2002–34

The IRS has received inquiries regarding the implementation of the new withholding and reporting requirements under §§ 1.1441 and 1.1461 of the Income Tax Regulations (T.D. 8734, 1997–2 C.B. 109 and T.D. 8881, 2000–23 I.R.B. 1158). Specifically, the IRS has recently become aware that some taxpayers (including, in particular, small taxpayers) are experiencing difficulty implementing the changes to the Form 1042–S reporting requirements (which require the filing of information returns to report certain payments to nonresident aliens). Under the regulations, a withholding agent must file Form(s) 1042–S with the IRS on or before March 15 of the calendar year following the year in which the amount subject to reporting was paid. See § 1.1461–1(c).

The IRS believes that ensuring the successful implementation of these new withholding and reporting procedures is in the best interests of sound tax administration. Accordingly, the IRS is extending the due date for filing 2001 Forms 1042–S from March 15, 2002, to May 15, 2002.

The principal author of this announcement is Laurie Hatten-Boyd of the Office of Associate Chief Counsel (International). For further information regarding this announcement, contact Ms. Hatten-Boyd at (202) 622–3840 (not a toll-free call).

Extension of Comment Period on White Paper on Future of Employee Plans Determination Letter Program

Announcement 2002–36

The Service is extending the comment period on its white paper on the long-term future of the Employee Plans (EP) determination letter program.

In Announcement 2001–83 (2001–35 I.R.B. 205), the Service invited the public to participate in a dialogue on the future of the EP determination letter program by submitting comments on a white paper that it had published on the Internet in August 2001. The white paper is entitled *The Future of the Employee Plans Determination Letter Program: Some Possible Options* and it may be downloaded from the Internet at the following site: *http://www.irs.gov/ep*. Announcement 2001–83 asked for written comments on the white paper to be submitted by March 31, 2002.

In order to provide an opportunity to those who wish to comment but are unable to do so by March 31, 2002, the Service is extending the comment period under Announcement 2001–83 to July 1, 2002. Commentators are also asked to comment on whether the Service should hold a series of nationwide town meetings to permit furtherance of dialogue on the future of the EP determination letter program. Comments should be submitted in duplicate and reference Announcement 2001–83. Comments should be sent to the following address:

CC:M&SP:RU
(Announcement 2001–83), room 5626
Internal Revenue Service
POB 7604, Ben Franklin Station
Washington, DC 20044

Alternatively, comments may be hand delivered between the hours of 8:30 a.m. and 4:30 p.m. to:

CC:M&SP:RU
(Announcement 2001–83)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC

All written comments will be open to public inspection.

DRAFTING INFORMATION

The principal author of this announcement is James Flannery of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this announcement, please contact Mr. Flannery at 1–202–283–9888 (not a toll-free number).

Changes in Method of Accounting

Announcement 2002–37

PURPOSE

In 1998, the Service published Notice 98–31 (1998–1 C.B. 1165), which proposed procedures for changes in method of accounting imposed by the Service under § 446(b) of the Internal Revenue Code and § 1.446–1(b) of the Income Tax Regulations ("involuntary changes"), and for accounting method issues resolved by the Service on a nonaccounting-method-change basis. Notice 98–31 also requested comments from the public in connection with these proposed procedures. The final involuntary change procedures appear concurrently in this Bulletin as Rev. Proc. 2002–18. The purpose of this announcement is to discuss some of the most significant and prevalent issues raised in the comments to Notice 98–31, and the manner in which those issues are addressed in the final guidance.

Along with Rev. Proc. 2002–18, this Bulletin contains Rev. Proc. 2002–19, which modifies the procedures contained in Rev. Proc. 97–27 (1997–1 C.B. 680) and Rev. Proc. 2002–9 (2002–3 I.R.B. 327) for taxpayers within the scope of those revenue procedures to obtain advance consent of the Commissioner, or automatic consent, respectively, to change a method of accounting ("voluntary changes"). Together, these three revenue procedures are intended to provide a more efficient use of Service and taxpayer resources with respect to accounting method issues and facilitate greater uniformity in the Service's resolution of accounting method issues.

CHANGES TO NOTICE 98–31

The Service received a number of comments in connection with Notice 98–31, which were considered carefully in revising and finalizing the proposed procedures in Rev. Proc. 2002–18. The following discussion describes some of the most significant comments and the manner in which the final guidance addresses them.

Commentators expressed concern that use of the term "timing issue" to describe the scope of the proposed procedures, and in particular an examining agent's discretion, inappropriately expanded the scope of the procedures to issues that affect timing but that should not be treated as changes in method of accounting, such as where the issue is an isolated occurrence or results from a change in underlying facts. The Service and Treasury Department did not intend to alter the definition of a change in method of accounting or to expand the scope of the proposed revenue procedure beyond issues concerning changes in method of accounting. To address the commentators' concerns, the final revenue procedure uses the term "accounting method issue" rather than "timing issue," clarifies the definition of an accounting method issue, and changes the reference for the definition of a change in method of accounting to § 1.446–1(e)(2).

Commentators expressed concern that the procedures set forth in Notice 98–31 would deprive examining agents of the authority to exercise discretion and professional judgment in resolving accounting method issues. Specifically, the commentators believed that the procedures would limit the existing authority of an examining agent to make findings of fact and to apply the law to those facts in determining whether an issue is an accounting method issue and whether the taxpayer's method of accounting is permissible. Rev. Proc. 2002–18 makes clear that these procedures do not limit or expand an examining agent's authority under existing delegation orders. Under Rev. Proc. 2002–18, an examining agent's ability to exercise professional judgment in accordance with existing auditing standards to make findings of fact, and to apply the law to the facts as found by the agent is preserved. Rev. Proc. 2002–18

also clarifies that although accounting method changes ordinarily will be implemented in the earliest open year under examination, and with a § 481(a) adjustment, there may be instances in which it is appropriate for an examining agent to consider deferring the year of change to a later year under examination, or to impose the change on a cut-off basis.

Similarly, some commentators believed that the procedures set forth in Notice 98–31 would limit the existing authority of Appeals and counsel for the government to resolve accounting method issues. Rev. Proc. 2002–18 clarifies that an appeals officer or counsel for the government may resolve an accounting method issue as an accounting method change (with or without compromise terms and conditions), using one of the nonaccounting-method change procedures provided in Rev. Proc. 2002–18, or using any other means deemed appropriate under the circumstances, consistent with existing delegation orders.

The background section of the proposed revenue procedure provides that the Service ordinarily will not initiate an accounting method change if the change will place the taxpayer in a position more favorable than if the taxpayer had not been contacted for examination (taxpayer-favorable change). Some commentators thought that this statement was out of place in a document intended to provide the procedures for how the Service will resolve accounting method issues that are raised on examination. The Service and Treasury Department agree that this statement does not belong in the background of the involuntary method change revenue procedure and thus have deleted it from Rev. Proc. 2002–18.

Consistent with Rev. Proc. 97–27 and Rev. Proc. 2002–9, the background section of the proposed revenue procedure provides that a change in the characterization of an item may constitute a change in method of accounting if the change has the effect of shifting income from one period to another. Some commentators objected to the inclusion of this statement, questioning whether a change in characterization of an item is properly considered a change in method of accounting and, in any event, whether such a rule belongs in the revenue procedures. Consistent with the purpose of these documents to provide procedural, rather than substantive, rules governing changes in method of accounting, the Service and the Treasury Department have not included section 2.01(3) of Notice 98–31 in Rev. Proc. 2002–18. Further, similar paragraphs have been removed from Rev. Proc. 97–27 and Rev. Proc. 2002–9 by Rev. Proc. 2002–19. The Service and Treasury Department are considering issuing separate guidance to address the issue of characterization in the context of a guidance project regarding the definition of a change in method of accounting.

The Service and Treasury Department were considering including guidance regarding the effect of closed years following the year of change (closed intervening years) in the final revenue procedure. In response to a specific request to opine as to the effect of closed intervening years, commentators suggested that substantive guidance addressing this issue should not be set forth in the final revenue procedure. Upon further consideration, the Service and Treasury Department agree that the resolution of this legal issue should not be set forth in Rev. Proc. 2002–18 and are considering issuing separate guidance to address this issue.

Finally, some commentators objected to the fact that, under Notice 98–31, the specified amount payable in the case of accounting method issues resolved by Appeals or counsel for the government on a time-value-of-money (TVM) basis is not treated as interest under § 163, and is not deductible under any provision of the Code. The commentators argued that this limitation was effectively punitive, and made the TVM alternative less attractive. In fact, as the sample computation contained in Notice 98–31 illustrates, the computation of the specified amount should be based on a tax-effected tax rate for taxpayers that would otherwise be entitled to a deduction if the specified amount were treated as interest under the Code. The use of a tax-effected rate effectively allows a deduction for the specified amount. A sentence is included in the final revenue procedure to clarify the use of tax-effected rates.

The Service and Treasury Department recognize that the TVM resolution has not been widely tested in practice, and that as the Service and taxpayers gain experience with this alternative, issues may arise that will require further clarifying guidance. The Service and Treasury Department anticipate that the TVM resolution will be most attractive in situations where it would be unnecessary to perform the complex interest credit calculation upon a subsequent change in method, such as when the resolution includes all years preceding a point at which a statutorily prescribed method becomes effective, a safe harbor method becomes available and is elected, or the issue of the proper method is otherwise resolved.

RELATED GUIDANCE

In addition to the proposed revenue procedure, Notice 98–31 outlined other guidance that the Service intended to publish as part of a comprehensive, and interrelated, set of procedures for resolving accounting method issues raised on audit. First, Notice 98–31 announced that the Service intended to publish guidance making the Coordinated Examination Program (CEP) early referral process provided in Rev. Proc. 96–9 (1996–1 C.B. 575) available to non-CEP taxpayers for the resolution of accounting method issues. This guidance has been published as Rev. Proc. 99–28 (1999–2 C.B. 109). By expanding the early referral procedures to include all taxpayers with respect to accounting method issues, the Service intends to provide a mechanism for expediting the resolution of those issues, which otherwise might be delayed pending the resolution of other (non-accounting-method) issues raised in the course of the audit.

Second, the Service announced that it intended to publish guidance that would permit taxpayers under examination who otherwise cannot request a voluntary change in method of accounting under the advance consent revenue procedure (Rev. Proc. 97–27) or the automatic consent revenue procedure (Rev. Proc. 2002–9) to do so prospectively without audit protection. That guidance is contained in Rev. Proc. 2002–19. The modification is intended to provide a means for taxpayers under examination with an accounting method issue pending, as well as taxpayers before an area appeals office or a federal court with an accounting method issue under consideration, to change their method of accounting on a going forward

basis while the issue is in the process of being resolved for prior taxable years. This new procedure set forth in Rev. Proc. 2002–19 does not limit or extend the existing authority of an examining agent, appeals officer, or counsel for the government to resolve accounting method issues raised on examination.

Also in connection with finalizing Notice 98–31 and the related guidance, the Service and Treasury Department have reconsidered the appropriateness of a 4-year § 481(a) adjustment period for voluntary accounting method changes that result in a negative adjustment. The Service and Treasury Department have concluded that the objectives of prompt voluntary compliance are enhanced by reducing the § 481(a) adjustment period for such changes from 4 years to 1 year. This new 1-year § 481(a) adjustment period, reflected in Rev. Proc. 2002–19, is effective for taxable years ending on or after December 31, 2001.

Third, Notice 98–31 provided that the Service intended to publish a model closing agreement for Service-initiated accounting method changes in order to provide greater uniformity in the Service's resolution of accounting method issues. Appendices A and B of Rev. Proc. 2002–18 provide model closing agreements for use in finalizing accounting method changes imposed by the Service, and for finalizing accounting method issues resolved by the Service on a nonaccounting-method-change basis, respectively. Closing agreements are encouraged, but not required, in the case of accounting method issues resolved as accounting method changes. Closing agreements are required for accounting method issues resolved on a nonaccounting-method-change basis. In response to comments, the Service is considering whether it would be appropriate to change the existing delegation orders to authorize approval of closing agreements for accounting method change issues at lower levels.

Fourth, Notice 98–31 referred to certain other anticipated guidance projects (*i.e.*, guidance that would delegate limited discretionary authority to Examination to resolve certain accounting method issues, and guidance to expand the accelerated issue resolution procedures of Rev. Proc. 94–67 (1994–2 C.B. 800) to non-CEP taxpayers to allow these taxpayers and the Service to resolve accounting method issues for taxable years beyond the years under examination, before appeals, or before a federal court). The Service is interested in receiving comments from taxpayers and practitioners on the extent to which there is a need for this guidance.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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2002-14

Internal Revenue bulletin

Bulletin No. 2002–14
April 8, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

SPECIAL ANNOUNCEMENTS

Announcement 2002–41, page 739.
The Director of Practice has extended all enrollment cards of enrolled agents until April 30, 2002.

Announcement 2002–42, page 739.
The Director of Practice has extended all existing continuing professional education sponsor agreements through August 31, 2002.

INCOME TAX

Rev. Rul. 2002–17, page 716.
Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2002.

T.D. 8985, page 707.
Final regulations under section 1221 of the Code relate to the determination of the character of gain or loss from hedging transactions.

Notice 2002–21, page 730.
This notice addresses a transaction generating tax losses based on an inflated basis in assets acquired from another party. The inflated basis is claimed as a result of a transfer of assets in which a taxpayer becomes jointly and severally liable on indebtedness of the transferor, with the indebtedness having a stated principal amount substantially in excess of the fair market value of the assets transferred. The notice states that the taxpayer's basis in the assets transferred is equal to the fair market value of such assets upon their acquisition by the taxpayer rather than the stated principal amount of the indebtedness.

Rev. Proc. 2002–20, page 732.
Guidance is provided to individuals who fail to meet the eligibility requirements of section 911(d)(1) of the Code because adverse conditions in a foreign country preclude the individual from meeting those requirements. A current list of countries and the dates those countries are subject to the section 911(d)(4) waiver is provided. Rev. Proc. 2001–27 supplemented.

EXEMPT ORGANIZATIONS

Announcement 2002–39, page 738.
Section 911(d)(4) waiver. This document contains corrections to final regulations (T.D. 8978, 2002–7 I.R.B. 500) relating to the excise taxes on excess benefit transactions.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXCISE TAX

Ct. D. 2073, page 718.
The Supreme Court has concluded, that under sections 4401(a), 1441, 3402(q), 6041, and 6050I of the Code, tribes are not exempt from paying the gambling-related taxes that Chapter 35 of the Code imposes. **Chickasaw Nation v. United States.**

Announcement 2002–39, page 738.
This document contains corrections to final regulations (T.D. 8978, 2002–7 I.R.B. 500) relating to the excise taxes on excess benefit transactions.

TAX CONVENTIONS

Page 725.
The bilateral agreement between the United States and the Republic of Ghana, providing for the reciprocal tax exemption of income from the international operation of ships and/or aircraft, is set forth.

ADMINISTRATIVE

Notice 2002–22, page 731.
Guidance priority list. Public comments are requested about items that should be included in the Guidance Priority List for 2002–2003. All comments should be submitted by April 30, 2002.

Rev. Proc. 2002–22, page 733.
Undivided fractional interests in real estate. This procedure specifies the conditions under which the Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity within the meaning of section 301.7701–3 of the regulations. Rev. Proc. 2000–46 superseded. Rev. Proc. 2002–3 modified.

Announcement 2002–38, page 738.
This document contains corrections to proposed regulations (REG–112991–01, 2002–4 I.R.B. 404) relating to the computation of the research credit.

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Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

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The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

26 CFR 1.267(a)–1: Deductions disallowed.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 511.—Imposition of Tax on Unrelated Business Income of Charitable, etc., Organizations

26 CFR 1.511–1: Imposition and rates of tax.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 512.—Unrelated Business Taxable Income

26 CFR 1.512(a)–1: Definition.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 707.—Transactions Between Partner and Partnership

26 CFR 1.707–1: Transactions between partner and partnership.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 761.—Terms Defined

26 CFR 1.761–1: Terms defined.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 856.—Definition of Real Estate Investment Trust

26 CFR 1.856–1: Definition of real estate investment trust.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 1031.—Exchange of Property Held For Productive Use or Investment

26 CFR 1.1031(a)–1: Property held for productive use in trade or business or for investment.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 1221.—Capital Asset Defined

26 CFR 1.1221–2: Hedging transactions.

T.D. 8985

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Hedging Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the character of gain or loss from hedging transactions. The regulations reflect changes to the law made by the Ticket to Work and Work Incentives Improvement Act of 1999. The regulations affect businesses entering into hedging transactions.

DATES: *Effective Date*: These regulations are effective March 20, 2002.

Applicability Dates: For dates of applicability of these regulations, see the discussion in the Dates of Applicability paragraph in the Supplementary Information portion of the preamble.

FOR FURTHER INFORMATION CONTACT: Elizabeth Handler, (202) 622–3930 or Viva Hammer at (202) 622–0869 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1480. Some responses to these collections of information are mandatory, and others are required to obtain the benefit of the separate-entity election.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent or recordkeeper varies from .1 to 40 hours, depending on individual circumstances, with an estimated average of 5.9 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR: MP:FP:S, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR Part 1 under section 1221 of the Internal Revenue Code (Code). Prior to amendment in 1999, section 1221 generally defined a capital asset as property held by the taxpayer other than: (1) Stock in trade or other types of assets includible in inventory; (2) property used in a trade or business that is real property or property subject to depreciation; (3) certain copyrights (or similar property); (4) accounts or notes receivable acquired in the ordinary course of a trade or business; and (5) U.S. government publications.

In 1994, the IRS published in the **Federal Register** (T.D. 8555, 1994–2 C.B. 180 [59 FR 36360]) final Treasury regulations under section 1221 providing for ordinary character treatment for certain business hedges. The regulations generally apply to transactions that reduce risk with respect to ordinary property, ordinary obligations, and borrowings of the taxpayer and that meet certain identification requirements. (§ 1.1221–2). In 1996, the IRS published in the **Federal Register** (T.D. 8653, 1996–1 C.B. 67 [61 FR 517]) final regulations on the character and timing of gain or loss from hedging transactions entered into by members of a consolidated group. In this preamble, the final regulations published in 1994 and 1996 are referred to collectively as the Treasury regulations.

On December 17, 1999, section 1221 was amended by section 532 of the Ticket to Work and Work Incentives Improvement Act of 1999 (113 Stat 1860) to provide ordinary gain or loss treatment for hedging transactions and consumable supplies. Section 1221(a)(7) provides ordinary treatment for hedging transactions that are clearly identified as such before the close of the day on which they were acquired, originated, or entered into.

The statute defines a hedging transaction as a transaction entered into by the taxpayer in the normal course of business primarily to manage risk of interest rate, price changes, or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the

taxpayer. Sections 1221(b)(2)(A)(i) and (ii). The statutory definition of hedging transaction also includes transactions to manage such other risks as the Secretary may prescribe in regulations. Section 1221(b)(2)(A)(iii). Further, the statute grants the Secretary the authority to provide regulations to address the treatment of nonidentified or improperly identified hedging transactions, and hedging transactions involving related parties (sections 1221(b)(2)(B) and (b)(3), respectively). The statutory hedging provisions are effective for transactions entered into on or after December 17, 1999. Congress intended that the hedging rules be the exclusive means through which the gains and losses from hedging transactions are treated as ordinary. S. Rep. No. 201, 106th Cong., 1st Sess. 25 (1999).

Section 1221(a)(8) provides that supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business are not capital assets. That provision is effective for supplies held or acquired on or after December 17, 1999.

A notice of proposed rulemaking (REG–107047–00, 2001–14 I.R.B. 1002) was published in the **Federal Register** (66 FR 4738) on January 18, 2001. On May 16, 2001, the IRS held a public hearing on the proposed regulations. Written comments responding to the notice of proposed rulemaking were also received. In response to these comments, the proposed regulations were modified and as so modified are adopted as final regulations. The principal changes to the proposed regulations are discussed below.

Explanation of Provisions

Coordination with International Provisions of the Code

The provisions of these regulations generally apply to determine the character of gain or loss from transactions that are also subject to various international provisions of the Code. Paragraph (a)(4) of the regulations, however, provides that the character of gain or loss on section 988 transactions is not determined under these regulations because gain or loss on those transactions is ordinary under section 988(a)(1). In addition, no implication is intended as to what constitutes "risk management" or "managing risk" for purposes of proposed or final regulations under section 482.

Paragraph (a)(4) of the proposed regulations provided that the definition of a hedging transaction under § 1.1221–2(b) of the proposed regulations would apply for purposes of certain other international provisions of the Code only to the extent provided in regulations issued under those provisions. Technical changes have been made in the final regulations to eliminate references to proposed regulations as well as Code sections for which the relevant regulations have not been issued in final form. Subsequent regulations will specify the extent to which the rules relating to hedging transactions that are contained in § 1.1221–2 will be applicable for purposes of those other regulations and related Code sections.

Risk Management Standard

Several commentators noted that the proposed regulations used risk reduction as the operating standard to implement the risk management definition of hedging introduced by section 1221(b)(2)(A). These commentators found that risk reduction is too narrow a standard to encompass the intent of Congress which defined hedges to include transactions that manage risk of interest rate, price changes or currency fluctuations. They urged the IRS and Treasury to adopt a broader definition of hedging to reflect Congress' intent. With one exception, the commentators did not suggest a definition of risk management.

In response to these comments, the final regulations have been restructured to implement the risk management standard. No definition of risk management is provided, but instead, the rules characterize a variety of classes of transactions as hedging transactions because they manage risk. Risk reducing transactions still qualify as one class of hedging transactions, but there are also others. In addition, specific provision is made for the recognition of additional types of qualifying risk management transactions through published guidance or private letter rulings. Under the final regulations, as under the proposed regulations, transactions entered into for speculative purposes will not qualify as hedging transactions. See S. Rep. No. 201, 106th Cong., 1st Sess. 24 (1999).

Application on the Basis of Separate Business Units

The proposed regulations provided that a taxpayer has risk of a particular type only if it is at risk when all of its operations are considered. That is, risk must exist on a "macro" basis. For this purpose, under the proposed regulations, a taxpayer has to show that hedges of particular assets or liabilities, or groups of assets or liabilities, are reasonably expected to reduce the overall risk of the taxpayer's operations.

Commentators pointed out that this entity-based approach to hedging is no longer uniform business practice. Instead, businesses often conduct risk management on a business unit by business unit basis. In response to these comments, the final regulations permit the determination of whether a transaction manages risk to be made on a business unit basis provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. An example was added to the final regulations in which for one taxpayer, the determination of whether hedging activities reduce risk is made at the business unit level. In the example, the conduct of risk management activities within separate business units is undertaken as part of a program to reduce the overall risk of the taxpayer's operations.

Fixed-to-floating Interest Rate Hedges

Paragraph (c)(1) of the proposed regulations recognized that a transaction that economically converts an interest rate or price from a fixed rate or price to a floating rate or price may manage risk. Commentators suggested that the rule in the proposed regulations provides insufficient guidance in that it states only that fixed-to-floating interest rate or price hedges may be hedging transactions. In response to these comments, the regulations have been restructured to separately address interest rate hedges and price hedges.

Commentators suggested that in the case of interest rate conversions, a taxpayer may choose to convert from a floating to a fixed rate to fix the amount payable on the obligation. However, a taxpayer could also elect to convert from a fixed to a floating rate to insure that the value of the liability remained relatively

constant. In response to these comments, the final regulations provide that a transaction that converts an interest rate from a fixed rate to a floating rate or from a floating rate to a fixed rate manages risk. With respect to fixed-to-floating price hedges, the final regulations adopt the proposed rules without change.

Transactions Not Entered into Primarily to Manage Risk

Paragraph (c)(3) of the proposed regulations provided that the purchase or sale of certain assets will not qualify as a hedging transaction if the assets are not acquired primarily to manage risk. This rule was illustrated by the example of a taxpayer that has an interest rate risk from a floating rate borrowing and that acquires debt instruments bearing a comparable floating interest rate. Although the taxpayer's interest rate risk from the floating rate borrowing may be reduced by the purchase of the floating rate debt instruments, the proposed regulations provided that the acquisition of the debt instruments is not made primarily to reduce risk and, therefore, is not a hedging transaction.

The IRS and Treasury understand that some employers may invest in assets (such as shares of a mutual fund) that are used as a reference investment for purposes of computing their liability to employees under a nonqualified deferred compensation plan. A question may arise whether such an investment may constitute a hedging transaction and, if so, whether income from the investment may be deferred by the employer until payments of deferred compensation are made to employees. See § 1.446–4(b); but compare *Albertson's, Inc. v. Commissioner*, 42 F.3d 537 (9th Cir. 1994).

The rule in the proposed regulations is based on § 1.1221–2(c)(1)(vii). The rule has been restated in the final regulations to refer specifically to investments in debt instruments, equity securities, and annuity contracts so as to provide greater certainty in its application. For this purpose certain transactions in instruments that are not themselves debt instruments may include a debt investment. See, *e.g.*, § 1.446–3(g)(4). Further, the final regulations provide that the IRS may identify by future published guidance specified transactions that are determined not to be entered into primarily to manage risk. An example has been added to the final regulations to illustrate that an investment in mutual fund shares in the case described in the preceding paragraph does not qualify as a hedging transaction. A similar example is added with respect to an investment in an annuity contract.

Hedging Risks Other Than Interest Rate or Price Changes, or Currency Fluctuations

Paragraph (c)(8) of the proposed regulations provided that the Commissioner may, by published guidance, provide that hedging transactions include transactions entered into to manage risks other than interest rate or price changes, or currency fluctuations.

The notice of proposed rulemaking solicited comments regarding the expansion of the definition of hedging transactions to include transactions that manage risks other than interest rate or price changes, or currency fluctuations with respect to ordinary property, ordinary obligations or borrowings of the taxpayer. Some comments were received in response to that request. Because the comments described hedging transactions that related to the general operating results of a business (such as gross sales) rather than specific ordinary property, ordinary obligations or borrowings of the taxpayer, the implementation of rules respecting such hedges would present a number of issues not easily dealt with by the rules contained in the final regulations. Thus, the expansion of the scope of operation of the hedging rules is not being proposed at this time, so as not to delay the publication of guidance on the matters that are covered by the final regulations. However, the IRS is continuing to consider whether to expand the definition of hedging transactions to cover hedges of such other risks. The IRS and Treasury invite comments on the types of risks that should be covered, including specific examples of derivative transactions that may be incorporated into future guidance, as well as the appropriate timing of inclusion of gains and losses with respect to such transactions. Send submissions to: CC:ITA:RU (REG–107047–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

"Gap" Hedges

The status of so-called gap hedges was not separately addressed in the proposed regulations and is not covered in the final regulations. Insurance companies, for example, sometimes hedge the gap between their liabilities and the assets that fund them. Under the final regulations, a hedge of those assets would not qualify as a hedging transaction if the assets are capital assets. Whether a gap hedge qualifies as a liability hedge is a question of fact and depends on whether it is more closely associated with the liabilities than with the assets.

Identification Requirement

A rule has been added specifying additional information that must be provided for a transaction that counteracts a hedging transaction.

Dates of Applicability

The regulations generally apply to all transactions entered into on or after March 20, 2002. However, the IRS will not challenge any transaction entered into on or after December 17, 1999, and before March 20, 2002, that satisfies the provisions of either § 1.1221–2 of REG–107047–00 (2001–14 I.R.B. 1002), published in the **Federal Register** (66 FR 4738) on January 18, 2001, or the provisions of this final regulation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that very few small businesses enter into hedging transactions due to their cost and complexity. Further, those small businesses that hedge enter into very few hedging transactions because hedging transactions are costly, complex, and require constant monitoring and a sophisticated understanding of the capital markets. Therefore, a Regulatory Flexibility Analysis under the Regulatory

Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Elizabeth Handler, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.1221–2 to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1221–2 also issued under 26 U.S.C. 1221(b)(2)(A)(iii), (b)(2)(B), and (b)(3); 1502 and 6001. * * *

Par. 2. In the list below, for each location indicated in the left column, remove the language in the middle column from that section, and add the language in the right column.

Affected section	Remove	Add
1.446–4(d)(2), first sentence	1.1221–2(e)	1.1221–2(f)
1.446–4(d)(2), last sentence	1.1221–2(e)(2)	1.1221–2(f)(2)
1.446–4(d)(3), first sentence	1.1221–2(e)	1.1221–2(f)
1.446–4(d)(3), last sentence	1.1221–2(a)(4)(i)	1.1221–2(a)(4)
1.446–4(e)(7), first sentence	1.1221–2(c)(2)	1.1221–2(d)(4)
1.446–4(e)(9)(ii), first sentence	1.1221–2(d)(2)	1.1221–2(e)(2)
1.446–4(e)(9)(ii), last sentence	1.1221–2(d)(2)(ii)	1.1221–2(e)(2)(ii)
1.475(b)–1(d)(2)	1.1221–2(e)	1.1221–2(f)
1.954–2(a)(4)(ii)(A), first sentence	1.1221–2(a) through (c)	1.1221–2(a) through (d)
1.954–2(a)(4)(ii)(B), first sentence	1.1221–2(e)	1.1221–2(f)
1.954–2(g)(2)(ii)(B)(2), last sentence	1.1221–2(c)(7)	1.1221–2(c)(3)
1.954–2(g)(3)(i)(B), last sentence	1.1221–2(c)(7)	1.1221–2(c)(3)
1.1256(e)–1(b), first and last sentences	1.1221–2(e)(1)	1.1221–2(f)(1)
1.1256(e)–1(c), first sentence	1.1221–2(e)(1)	1.1221–2(f)(1)
1.1256(e)–1(c), last sentence	paragraph (f)(1)(ii) of § 1.1221–2	1.1221–2(g)(1)(ii)

Par. 3. Section 1.1221–2 is revised to read as follows:

§ 1.1221–2 Hedging transactions.

(a) *Treatment of hedging transactions*—(1) *In general.* This section governs the treatment of hedging transactions under section 1221(a)(7). Except as provided in paragraph (g)(2) of this section, the term capital asset does not include property that is part of a hedging transaction (as defined in paragraph (b) of this section).

(2) *Short sales and options.* This section also governs the character of gain or loss from a short sale or option that is part of a hedging transaction. Except as provided in paragraph (g)(2) of this section, gain or loss on a short sale or option that is part of a hedging transaction (as defined in paragraph (b) of this section) is ordinary income or loss.

(3) *Exclusivity.* If a transaction is not a hedging transaction as defined in paragraph (b) of this section, gain or loss from the transaction is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

(4) *Coordination with section 988.* This section does not apply to determine the character of gain or loss realized on a section 988 transaction as defined in section 988(c)(1) or realized with respect to any qualified fund as defined in section 988(c)(1)(E)(iii).

(b) *Hedging transaction defined.* Section 1221(b)(2)(A) provides that a hedging transaction is any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

(1) To manage risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(2) of this section) that is held or to be held by the taxpayer;

(2) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or

(3) To manage such other risks as the Secretary may prescribe in regulations (see paragraph (d)(6) of this section).

(c) *General rules*—(1) *Normal course.* Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer's trade or business, the transaction is entered into

in the normal course of the taxpayer's trade or business. This rule includes managing risks relating to the expansion of an existing business or the acquisition of a new trade or business.

(2) *Ordinary property and obligations.* Property is ordinary property to a taxpayer only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss under any circumstances. Thus, for example, property used in a trade or business within the meaning of section 1231(b) (determined without regard to the holding period specified in that section) is not ordinary property. An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. For purposes of this paragraph (c)(2), the term termination has the same meaning as it does in section 1234A.

(3) *Hedging an aggregate risk.* The term hedging transaction includes a transaction that manages an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but a *de minimis* amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings.

(4) *Managing risk*—(i) *In general.* Whether a transaction manages a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction. Whether a transaction manages a taxpayer's risk may be determined on a business unit by business unit basis (for example by treating particular groups of activities, including the assets and liabilities attributable to those activities, as separate business units), provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. A taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions were entered into primarily to manage the taxpayer's risk.

(ii) *Limitation of risk management transactions to those specifically described.* Except as otherwise determined by published guidance or by private letter ruling, a transaction that is not treated as a hedging transaction under paragraph (d) does not manage risk. Moreover, a transaction undertaken for speculative purposes will not be treated as a hedging transaction.

(d) *Transactions that manage risk*—(1) *Risk reduction transactions*—(i) *In general.* A transaction that is entered into to reduce a taxpayer's risk, manages a taxpayer's risk.

(ii) *Micro and macro hedges*—(A) *In general.* A taxpayer generally has risk of a particular type only if it is at risk when all of its operations are considered. Nonetheless, a hedge of a particular asset or liability generally will be respected as reducing risk if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer's operations. If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedges are undertaken as part of a program that, as a whole, is reasonably expected to reduce the overall risk of the taxpayer's operations, the taxpayer generally does not have to demonstrate that each hedge that was entered into pursuant to the program reduces its overall risk.

(B) *Example.* The following example illustrates the rules stated in paragraph (d)(1)(ii)(A) of this section:

Example. Corporation X manages its business operations by treating particular groups of activities, including the assets and liabilities attributable to those assets, as separate business units. A separate set of books and records is maintained with respect to the activities, assets and liabilities of separate business unit *y*. As part of a risk management program that Corporation X reasonably expects to reduce the overall risks of its business operations, Corporation X enters into hedges to reduce the risks of separate business unit *y*. Corporation X may demonstrate that the hedges reduce risk by taking into account only the activities, assets and liabilities of business unit *y*.

(iii) *Written options.* A written option may reduce risk. For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer or a written put option with respect to assets to be acquired by a taxpayer may be a hedging transaction. See also paragraph (d)(3) of this section.

(iv) *Fixed-to-floating price hedges.* Under the principles of paragraph (d)(1)(ii)(A) of this section, a transaction that economically converts a price from a fixed price to a floating price may reduce risk. For example, a taxpayer with a fixed cost for its inventory may be at risk if the price at which the inventory can be sold varies with a particular factor. Thus, for such a taxpayer a transaction that converts its fixed price to a floating price may be a hedging transaction.

(2) *Interest rate conversions.* A transaction that economically converts an interest rate from a fixed rate to a floating rate or that converts an interest rate from a floating rate to a fixed rate manages risk.

(3) *Transactions that counteract hedging transactions.* If a transaction is entered into primarily to offset all or any part of the risk management effected by one or more hedging transactions, the transaction is a hedging transaction. For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, then it may be a hedging transaction.

(4) *Recycling.* A taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability as a hedge of another asset or liability (recycling).

(5) *Transactions not entered into primarily to manage risk*—(i) *Rule.* Except as otherwise determined in published guidance or private letter ruling, the purchase or sale of a debt instrument, an equity security, or an annuity contract is not a hedging transaction even if the transaction limits or reduces the taxpayer's risk with respect to ordinary property, borrowings, or ordinary obligations. In addition, the Commissioner may determine in published guidance that other transactions are not hedging transactions.

(ii) *Examples.* The following examples illustrate the rule stated in paragraph (d)(5)(i) of this section:

Example 1. Taxpayer borrows money and agrees to pay a floating rate of interest. Taxpayer purchases debt instruments that bear a comparable floating rate. Although taxpayer's interest rate risk from the floating rate borrowing may be reduced by the purchase of the debt instruments, the acquisition of the debt instruments is not a hedging transaction, because the transaction is not entered into primarily to manage the taxpayer's risk.

Example 2. Taxpayer undertakes obligations to pay compensation in the future. The amount of the future compensation payments is adjusted as if amounts were invested in a specified mutual fund and were increased or decreased by the earnings, gains and losses that would result from such an investment. Taxpayer invests funds in the shares of the mutual fund. Although the investment in shares of the mutual fund reduces the taxpayer's risk of fluctuation in the amount of its obligation to employees, the investment was not made primarily to manage the taxpayer's risk. Accordingly, the transaction is not a hedging transaction.

Example 3. Taxpayer provides a nonqualified retirement plan for employees that is structured like a defined contribution plan. Based on a schedule that takes into account an employee's monthly salary and years of service with the taxpayer, the taxpayer makes monthly credits to an account for each employee. Each employee may designate that the account will be treated as if it were used to pay premiums on a variable annuity contract issued by the M insurance company with a value that reflects a specified investment option. M offers a number of investment options for its variable annuity contracts. Taxpayer invests funds in M company variable annuity contracts that parallel the investment options selected by the employees. The investment is not made primarily to manage the taxpayer's risk and is not a hedging transaction.

(6) *Hedges of other risks.* The Commissioner may, by published guidance, determine that hedging transactions include transactions entered into to manage risks other than interest rate or price changes, or currency fluctuations.

(7) *Miscellaneous provision*—(i) *Extent of risk management.* A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to the risk.

(ii) *Number of transactions.* The fact that a taxpayer frequently enters into and terminates positions (even if done on a daily or more frequent basis) is not relevant to whether these transactions are hedging transactions. Thus, for example, a taxpayer hedging the risk associated with an asset or liability may frequently establish and terminate positions that hedge that risk, depending on the extent the taxpayer wishes to be hedged. Similarly, if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, its transactions may nonetheless qualify as hedging transactions.

(e) *Hedging by members of a consolidated group*—(1) *General rule: single-entity approach.* For purposes of this section, the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation. For example, if any member of a consolidated group hedges the risk of another member of the group by entering into a transaction with a third party, that transaction may potentially qualify as a hedging transaction. Conversely, intercompany transactions are not hedging transactions because, when considered as transactions between divisions of a single corporation, they do not manage the risk of that single corporation.

(2) *Separate-entity election.* In lieu of the single-entity approach specified in paragraph (e)(1) of this section, a consolidated group may elect separate-entity treatment of its hedging transactions. If a group makes this separate-entity election, the following rules apply:

(i) *Risk of one member not risk of other members.* Notwithstanding paragraph (e)(1) of this section, the risk of one member is not treated as the risk of other members.

(ii) *Intercompany transactions.* An intercompany transaction is a hedging transaction (an intercompany hedging transaction) with respect to a member of a consolidated group if and only if it meets the following requirements—

(A) The position of the member in the intercompany transaction would qualify as a hedging transaction with respect to the member (taking into account paragraph (e)(2)(i) of this section) if the member had entered into the transaction with an unrelated party; and

(B) The position of the other member (the marking member) in the transaction is marked to market under the marking member's method of accounting.

(iii) *Treatment of intercompany hedging transactions.* An intercompany hedging transaction (that is, a transaction that meets the requirements of paragraphs (e)(2)(ii)(A) and (B) of this section) is subject to the following rules—

(A) The character and timing rules of § 1.1502–13 do not apply to the income, deduction, gain, or loss from the intercompany hedging transaction; and

(B) Except as provided in paragraph (g)(3) of this section, the character of the marking member's gain or loss from the transaction is ordinary.

(iv) *Making and revoking the election.* Unless the Commissioner otherwise prescribes, the election described in this paragraph (e)(2) must be made in a separate statement saying "[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF SECTION 1.1221–2(e)(2) (THE SEPARATE-ENTITY APPROACH)." The statement must also indicate the date as of which the election is to be effective. The election must be signed by the common parent and filed with the group's Federal income tax return for the taxable year that includes the first date for which the election is to apply. The election applies to all transactions entered into on or after the date so indicated. The election may be revoked only with the consent of the Commissioner.

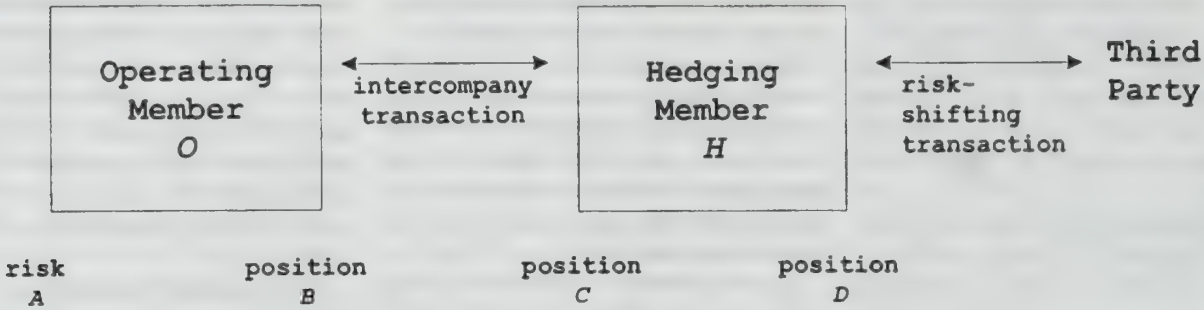
(3) *Definitions.* For definitions of consolidated group, divisions of a single corporation, group, intercompany transactions, and member, see section 1502 and the regulations thereunder.

(4) *Examples. General Facts.* In these examples, *O* and *H* are members of the same consolidated group. *O*'s business operations give rise to interest rate risk "*A*," which *O* wishes to hedge. *O* enters into an intercompany transaction with *H* that transfers the risk to *H*. *O*'s position in the intercompany transaction is "*B*," and *H*'s position in the transaction is "*C*." *H* enters into position "*D*" with a third party to reduce the interest rate risk it has with respect to its position *C*. *D* would be a hedging transaction with respect to risk *A* if *O*'s risk *A* were *H*'s risk. The following examples illustrate this paragraph (e):

Example 1. Single-entity treatment—(i) *General rule.* Under paragraph (e)(1) of this section, *O*'s risk *A* is treated as *H*'s risk, and therefore *D* is a hedging transaction with respect to risk *A*. Thus, the character of *D* is determined under the rules of this section, and the income, deduction, gain, or loss from *D* must be accounted for under a method of accounting that satisfies § 1.446–4. The intercompany transaction *B-C* is not a hedging transaction and is taken into account under § 1.1502–13.

(ii) *Identification. D* must be identified as a hedging transaction under paragraph (f)(1) of this section, and *A* must be identified as the hedged item under paragraph (f)(2) of this section. Under paragraph (f)(5) of this section, the identification of *A* as the hedged item can be accomplished by identifying the positions in the intercompany transaction as hedges or hedged items, as appropriate. Thus, substantially contemporaneous with entering into *D*, *H* may identify *C* as the hedged item and *O* may identify *B* as a hedge and *A* as the hedged item.

Example 2. Separate-entity election; counterparty that does not mark to market. In addition to the *General Facts* stated above, assume that the group makes a separate-entity election under paragraph (e)(2) of this section. If *H* does not mark *C* to market under its method of accounting, then *B* is not a hedging transaction, and the *B-C* intercompany transaction is taken into account under the rules of section 1502. *D* is not a hedging transaction with respect to *A*, but *D* may be a hedging transaction with respect to *C* if *C* is ordinary property or an ordinary obligation and if the other requirements of paragraph (b) of this section are met. If *D* is not part of a hedging transaction, then *D* may be part of a straddle for purposes of section 1092.



Example 3. Separate-entity election; counterparty that marks to market. The facts are the same as in *Example 2* above, except that *H* marks *C* to market under its method of accounting. Also assume that *B* would be a hedging transaction with respect to risk *A* if *O* had entered into that transaction with an unrelated party. Thus, for *O*, the *B-C* transaction is an intercompany hedging transaction with respect to *O*'s risk *A*, the character and timing rules of § 1.1502–13 do not apply to the *B-C* transaction, and *H*'s income, deduction, gain, or loss from *C* is ordinary. However, other attributes of the items from the *B-C* transaction are determined under § 1.1502–13. *D* is a hedging transaction with respect to *C* if it meets the requirements of paragraph (b) of this section.

(f) *Identification and recordkeeping*—(1) *Same-day identification of hedging transactions.* Under section 1221(a)(7), a taxpayer that enters into a hedging transaction (including recycling an existing hedging transaction) must clearly identify it as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction (or recycled the existing hedging transaction).

(2) *Substantially contemporaneous identification of hedged item*—(i) *Content of the identification.* A taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates. For example, if a taxpayer is hedging the price risk with respect to its June purchases of corn inventory, the transaction being hedged is the June purchase of corn and the risk is price movements in the market where the taxpayer buys its corn. For additional rules concerning the content of this identification, see paragraph (f)(3) of this section.

(ii) *Timing of the identification.* The identification required by this paragraph (f)(2) must be made substantially contemporaneously with entering into the hedging transaction. An identification is not substantially contemporaneous if it is made more than 35 days after entering into the hedging transaction.

(3) *Identification requirements for certain hedging transactions.* In the case of the hedging transactions described in this paragraph (f)(3), the identification under paragraph (f)(2) of this section must include the information specified.

(i) *Anticipatory asset hedges.* If the hedging transaction relates to the anticipated acquisition of assets by the taxpayer, the identification must include the expected date or dates of acquisition and the amounts expected to be acquired.

(ii) *Inventory hedges.* If the hedging transaction relates to the purchase or sale of inventory by the taxpayer, the identification is made by specifying the type or class of inventory to which the transaction relates. If the hedging transaction relates to specific purchases or sales, the identification must also include the expected dates of the purchases or sales and the amounts to be purchased or sold.

(iii) *Hedges of debt of the taxpayer*—(A) *Existing debt.* If the hedging transaction relates to accruals or payments under an issue of existing debt of the taxpayer, the identification must specify the issue and, if the hedge is for less than the full issue price or the full term of the debt, the amount of the issue price and the term covered by the hedge.

(B) *Debt to be issued.* If the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the expected maturity or maturities; the total expected issue price; and the expected interest provisions. If the hedge is for less than the entire expected issue price of the debt or the full expected term of the debt, the identification must also include the amount or the term being hedged. The identification may indicate a range of dates, terms, and amounts, rather than specific dates, terms, or amounts. For example, a taxpayer might identify a transaction as hedging the yield on an anticipated issuance of fixed rate debt during the second half of its fiscal year, with the anticipated amount of the debt between $75 million and $125 million, and an anticipated term of approximately 20 to 30 years.

(iv) *Hedges of aggregate risk*—(A) *Required identification.* If a transaction hedges aggregate risk as described in paragraph (c)(3) of this section, the identification under paragraph (f)(2) of this section must include a description of the risk being hedged and of the hedging program under which the hedging transaction was entered. This requirement may be met by placing in the taxpayer's records a description of the hedging program and by establishing a system under which individual transactions can be identified as being entered into pursuant to the program.

(B) *Description of hedging program.* A description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. If the program contains controls on speculation (for example, position limits), the description of the hedging program must also explain how the controls are established, communicated, and implemented.

(v) *Transactions that counteract hedging transactions.* If the hedging transaction is described in paragraph (d)(3) of this section, the description of the hedging transaction must include an identification of the risk management transaction that is being offset and the original underlying hedged item.

(4) *Manner of identification and records to be retained*—(i) *Inclusion of identification in tax records.* The identification required by this paragraph (f) must be made on, and retained as part of, the taxpayer's books and records.

(ii) *Presence of identification must be unambiguous.* The presence of an identification for purposes of this paragraph (f) must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. The taxpayer may indicate that individual hedging transactions, or a class or classes of hedging transactions, that are identified for financial accounting or regulatory purposes are also being identified as hedging transactions for purposes of this section.

(iii) *Manner of identification.* The taxpayer may separately and explicitly make each identification, or, so long as paragraph (f)(4)(ii) of this section is satisfied, the taxpayer may establish a system pursuant to which the identification is indicated by the type of transaction or by the manner in which the transaction is consummated or recorded. An identification under this system is made at the later of the time that the system is established or the time that the transaction satisfies the terms of the system by being entered, or by being consummated or recorded, in the designated fashion.

(iv) *Principles of paragraph (f)(4)(iii) of this section illustrated.* Paragraphs (f)(4)(iv)(A) through (C) of this section illustrate the principles of paragraph (f)(4)(iii) of this section and assume that the other requirements of this paragraph (f) are satisfied.

(A) A taxpayer can make an identification by designating a hedging transaction for (or placing it in) an account that has been identified as containing only hedges of a specified item (or of specified items or specified aggregate risk).

(B) A taxpayer can make an identification by including and retaining in its books and records a statement that designates all future transactions in a specified derivative product as hedges of a specified item, items, or aggregate risk.

(C) A taxpayer can make an identification by designating a certain mark, a certain form, or a certain legend as meaning that a transaction is a hedge of a specified item (or of specified items or a specified aggregate risk). Identification can be made by placing the designated mark on a record of the transaction (for example, trading ticket, purchase order, or trade confirmation) or by using the designated form or a record that contains the designated legend.

(5) *Identification of hedges involving members of the same consolidated group*—(i) *General rule: single-entity approach.* A member of a consolidated group must satisfy the requirements of this paragraph (f) as if all of the members of the group were divisions of a single corporation. Thus, the member entering into the hedging transaction with a third party must identify the hedging transaction under paragraph (f)(1) of this section. Under paragraph (f)(2) of this section, that member must also identify the item, items, or aggregate risk that is being hedged, even if the item, items, or aggregate risk relates primarily or entirely to other members of the group. If the members of a group use intercompany transactions to transfer risk within the group, the requirements of paragraph (f)(2) of this section may be met by identifying the intercompany transactions, and the risks hedged by the intercompany transactions, as hedges or hedged items, as appropriate. Because identification of the intercompany transaction as a hedge serves solely to identify the hedged item, the identification is timely if made within the period required by paragraph (f)(2) of this section. For example, if a member transfers risk in an intercompany transaction, it may identify under the rules of this paragraph (f) both its position in that transaction and the item, items, or aggregate risk being hedged. The member that hedges the risk outside the group may identify under the rules of this paragraph (f) both its position with the third party and its position in the intercompany transaction. Paragraph (e)(4) *Example 1* of this section illustrates this identification.

(ii) *Rule for consolidated groups making the separate-entity election.* If a consolidated group makes the separate-entity election under paragraph (e)(2) of this section, each member of the group must satisfy the requirements of this paragraph (f) as though it were not a member of a consolidated group.

(6) *Consistency with section 1256(e)(2).* Any identification for purposes of section 1256(e)(2) is also an identification for purposes of paragraph (f)(1) of this section.

(g) *Effect of identification and non-identification*—(1) *Transactions identified*—(i) *In general.* If a taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (f)(1) of this section, the identification is binding with respect to gain, whether or not all of the requirements of paragraph (f) of this section are satisfied. Thus, gain from that transaction is ordinary income. If the transaction is not in fact a hedging transaction described in paragraph (b) of this section, however, paragraphs (a)(1) and (2) of this section do not apply and the character of loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself make loss from the transaction ordinary.

(ii) *Inadvertent identification.* Notwithstanding paragraph (g)(1)(i) of this section, if the taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (f) of this section, the character of the gain is determined as if the transaction had not been identified as a hedging transaction if—

(A) The transaction is not a hedging transaction (as defined in paragraph (b) of this section);

(B) The identification of the transaction as a hedging transaction was due to inadvertent error; and

(C) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(2) *Transactions not identified*—(i) *In general.* Except as provided in paragraphs (g)(2)(ii) and (iii) of this section, the absence of an identification that satisfies the requirements of paragraph (f)(1) of this section is binding and establishes that a transaction is not a hedging transaction. Thus, subject to the exceptions, the rules of paragraphs (a)(1) and (2) of this section do not apply, and the character of gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose.

(ii) *Inadvertent error.* If a taxpayer does not make an identification that satisfies the requirements of paragraph (f) of this section, the taxpayer may treat gain or loss from the transaction as ordinary income or loss under paragraph (a)(1) or (2) of this section if—

(A) The transaction is a hedging transaction (as defined in paragraph (b) of this section);

(B) The failure to identify the transaction was due to inadvertent error; and

(C) All of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as provided in paragraphs (a)(1) and (2) of this section.

(iii) *Anti-abuse rule.* If a taxpayer does not make an identification that satisfies all the requirements of paragraph (f) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (b) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(3) *Transactions by members of a consolidated group*—(i) *Single-entity approach.* If a consolidated group is under the general rule of paragraph (e)(1) of this section (the single-entity approach), the rules of this paragraph (g) apply only to transactions that are not intercompany transactions.

(ii) *Separate-entity election.* If a consolidated group has made the election under paragraph (e)(2) of this section, then, in addition to the rules of paragraphs (g)(1) and (2) of this section, the following rules apply:

(A) If an intercompany transaction is identified as a hedging transaction but does not meet the requirements of paragraphs (e)(2)(ii)(A) and (B) of this section, then, notwithstanding any contrary provision in § 1.1502–13, each party to the transaction is subject to the rules of paragraph (g)(1) of this section with respect to the transaction as though it had incorrectly identified its position in the transaction as a hedging transaction.

(B) If a transaction meets the requirements of paragraphs (e)(2)(ii)(A) and (B) of this section but the transaction is not identified as a hedging transaction, each party to the transaction is subject to the rules of paragraph (g)(2) of this section. (Because the transaction is an intercompany hedging transaction, the character and timing rules of § 1.1502–13 do not apply. See paragraph (e)(2)(iii)(A) of this section.)

(h) *Effective date.* The rules of this section apply to transactions entered into on or after March 20, 2002.

Par. 4. Section 1.1256(e)–1 is revised to read as follows:

§ 1.1256(e)–1 Identification of hedging transactions.

(a) *Identification and recordkeeping requirements.* Under section 1256(e)(2), a taxpayer that enters into a hedging transaction must identify the transaction as a hedging transaction before the close of the day on which the taxpayer enters into the transaction.

(b) *Requirements for identification.* The identification of a hedging transaction for purposes of section 1256(e)(2) must satisfy the requirements of § 1.1221–2(f)(1). Solely for purposes of section 1256(f)(1), however, an identification that does not satisfy all of the requirements of § 1.1221–2(f)(1) is nevertheless treated as an identification under section 1256(e)(2).

(c) *Consistency with § 1.1221–2.* Any identification for purposes of § 1.1221–2(f)(1) is also an identification for purposes of this section. If a taxpayer satisfies the requirements of § 1.1221–2(f)(1)(ii), the transaction is treated as if it were not identified as a hedging transaction for purposes of section 1256(e)(2).

(d) *Effective date.* The rules of this section apply to transactions entered into on or after March 20, 2002.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In § 602.101, paragraph (b) is amended by removing the entries for "1.1221–2," "1.1221–2(d)(2)(iv)," "1.1221–2(e)(5)," "1.1221–2(g)(5)(ii)," "1.1221–2(g)(6)(ii)," "1.1221–2(g)(6)(iii)," and "1.1221–2T(c)" and adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1221–2	1545–1480
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved March 14, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 15, 2002, 8:54 a.m., and published in the issue of the Federal Register for March 20, 2002, 67 F.R. 12863)

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2002.

Rev. Rul. 2002–17

This revenue ruling provides various prescribed rates for federal income tax purposes for April 2002 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2002–17 TABLE 1

Applicable Federal Rates (AFR) for April 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	2.88%	2.86%	2.85%	2.84%
110% AFR	3.17%	3.15%	3.14%	3.13%
120% AFR	3.46%	3.43%	3.42%	3.41%
130% AFR	3.75%	3.72%	3.70%	3.69%
Mid-Term				
AFR	4.65%	4.60%	4.57%	4.56%
110% AFR	5.12%	5.06%	5.03%	5.01%
120% AFR	5.60%	5.52%	5.48%	5.46%
130% AFR	6.07%	5.98%	5.94%	5.91%
150% AFR	7.02%	6.90%	6.84%	6.80%
175% AFR	8.21%	8.05%	7.97%	7.92%
Long-Term				
AFR	5.62%	5.54%	5.50%	5.48%
110% AFR	6.18%	6.09%	6.04%	6.01%
120% AFR	6.76%	6.65%	6.60%	6.56%
130% AFR	7.33%	7.20%	7.14%	7.09%

REV. RUL. 2002–17 TABLE 2

Adjusted AFR for April 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	2.08%	2.07%	2.06%	2.06%
Mid-term adjusted AFR	3.52%	3.49%	3.47%	3.46%
Long-term adjusted AFR	4.87%	4.81%	4.78%	4.76%

REV. RUL. 2002–17 TABLE 3

Rates Under Section 382 for April 2002

Adjusted federal long-term rate for the current month	4.87%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.01%

REV. RUL. 2002–17 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for April 2002

Appropriate percentage for the 70% present value low-income housing credit	8.20%
Appropriate percentage for the 30% present value low-income housing credit	3.51%

REV. RUL. 2002–17 TABLE 5	
Rate Under Section 7520 for April 2002	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.6%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 1361.—S Corporation Defined

26 CFR 1.1361–1: S Corporation defined.

Under what conditions will the Internal Revenue Service consider a request for a ruling that an undivided interest in rental real property (other than a mineral property as defined in § 614) is not an interest in a business entity within the meaning of § 301.7701–3 of the Procedure and Administration Regulations? See Rev. Proc. 2002–22, page 733.

Section 4401.—Imposition of Tax

Ct. D. 2073

SUPREME COURT OF THE UNITED STATES

No. 00–507

CHICKASAW NATION *v.* UNITED STATES

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT
November 27, 2001*

Syllabus

The Indian Gaming Regulatory Act (Gaming Act) provides, as relevant here, that Internal Revenue Code (Code) provisions "(including [Secs.] 1441, 3402(q), 6041, and 6050I, and chapter 35 . . .) concerning the reporting and withholding of taxes" with respect to gambling operations shall apply to Indian tribes in the same way as they apply to States. 25 U.S.C. Sec. 2719(d)(i). Chapter 35 *imposes* taxes from which it exempts certain state-controlled gambling activities, but says nothing about tax *reporting or withholding*. Petitioners, the Choctaw and Chickasaw Nations, claim that the Gaming Act subsection's explicit parenthetical reference exempts them from paying those chapter 35 taxes from which the States are exempt. Rejecting that claim, the Tenth Circuit held that the subsection applies only to Code provisions concerning tax withholding and reporting.

Held: Section 2719(d)(i) does not exempt tribes from paying the gambling-related taxes that chapter 35 imposes. Pp. 3–11.

(a) The subsection's language outside the parenthetical says that the subsection applies to Code provisions concerning reporting and withholding, and the other four parenthetical references arguably concern reporting and withholding. The Tribes nonetheless claim that the subsection's explicit parenthetical reference to chapter 35 expands the Gaming Act's scope beyond reporting and withholding provisions — to the tax-imposing provisions that chapter 35 contains — and at the very least gives the subsection an ambiguity that can be resolved by applying the canon that statutes are to be construed liberally in favor of Indians with ambiguous provisions interpreted to their benefit. Rejecting their argument reduces the chapter 35 phrase to surplusage, but there is no other reasonable reading of the statute. Pp. 3–4.

(b) The statute's language is too strong to give the chapter 35 reference independent operative effect. The unambiguous language outside the parenthetical says without qualification that the subsection applies to "provisions . . . concerning the reporting and withholding of taxes"; and the language inside the parenthetical, prefaced with the word "including," literally says the same, since to "include" means to "contain." The use of parentheses emphasizes the fact that that which is within is meant simply to be illustrative. To give the chapter 35 reference independent operative effect would require seriously rewriting the rest of the statute. One would have to read "including" to mean what it does not mean, namely, "including. . . and." To read the language outside the parenthetical as if it referred to (1) Code provisions concerning tax reporting and withholding and (2) those "concerning . . . wagering operations" would be far too convoluted to believe Congress intended it. There is no reason to think Congress intended to sweep within the subsection's scope every Code provision concerning wagering. The subject matter at issue — tax exemption — also counsels against accepting the Tribes' interpretation. This Court can find no comparable instance in which Congress

*Together with *Choctaw Nation of Oklahoma v. United States* (see this Court's Rule 12.4), also on certiorari to the same court.

legislated an exemption through a parenthetical numerical cross-reference. Since the more plausible role for the parenthetical to play in this subsection is that of providing an illustrative list of examples, common sense suggests that "chapter 35" is simply a bad example that Congress included inadvertently, a drafting mistake. Pp. 4–6.

(c) The Gaming Act's legislative history on balance supports this Court's conclusion. And the canons of interpretation to which the Tribes point — that every clause and word of a statute should be given effect and that statutes are to be construed liberally in favor of the Indians with ambiguous provisions interpreted to their benefit — do not determine how to read this statute. First, the canons are guides that need not be conclusive. *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 115. To accept these canons as conclusive here would produce an interpretation that the Court firmly believes would conflict with congressional intent. Second, specific canons are often countered by some maxim pointing in a different direction. *Ibid.* The canon requiring a court to give effect to each word "if possible" is sometimes offset by the canon permitting a court to reject words as mere surplusage if inadvertently inserted or if repugnant to the rest of the statute. Moreover, the pro-Indian canon is offset by the canon warning against interpreting federal statutes as providing tax exemptions unless the exemptions are clearly expressed. Given the individualized nature of this Court's previous cases, one cannot say that the pro-Indian canon is inevitably stronger, particularly where the interpretation of a congressional statute rather than an Indian treaty is at issue. Pp. 6–11.

208 F.3d 871 (first judgment); 210 F.3d 389 (second judgment), affirmed.

BREYER, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and STEVENS, KENNEDY, and GINSBURG, JJ., joined, and in all but Part II-B of which SCALIA and THOMAS, JJ., joined. O'CONNOR, J., filed a dissenting opinion, in which SOUTER, J., joined.

SUPREME COURT OF THE UNITED STATES

No. 00–507

CHICKASAW NATION, PETITIONER *v.* UNITED STATES
CHOCTAW NATION OF OKLAHOMA, PETITIONER *v.* UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

November 27, 2001

JUSTICE BREYER delivered the opinion of the Court.*

In these cases, we must decide whether a particular subsection in the Indian Gaming Regulatory Act, 102 Stat. 2467–2486, 25 U.S.C. Secs. 2701–2721 (1994 ed.), exempts tribes from paying the gambling-related taxes that chapter 35 of the Internal Revenue Code imposes — taxes that States need not pay. We hold that it does not create such an exemption.

I

The relevant Indian Gaming Regulatory Act (Gaming Act) subsection, as codified in 25 U.S.C. Sec. 2719(d)(i), reads as follows:

> "The provisions of [the Internal Revenue Code of 1986] (including sections 1441, 3402(q), 6041, and 6050I, and chapter 35 of such Code) concerning the reporting and withholding of taxes with respect to the winnings from gaming or wagering operations shall apply to Indian gaming operations conducted pursuant to this chapter, or under a Tribal-State compact entered into under section 2710(d)(3) of this title that is in effect, in the same manner as such provisions apply to State gaming and wagering operations."

The subsection says that Internal Revenue Code provisions that "concer[n] the reporting and withholding of taxes" with respect to gambling operations shall apply to Indian tribes in the same way as they apply to States. The subsection also says in its parenthetical that those provisions "includ[e]" Internal Revenue Code "chapter 35." Chapter 35, however, says nothing about the *reporting* or the *withholding* of taxes. Rather, that chapter simply *imposes* taxes — excise taxes and occupational taxes related to gambling — from which it exempts certain state-controlled gambling activities. See, *e.g.*, 26 U.S.C. Sec. 4401(a) (1994 ed.) (imposing 0.25% excise tax on each wager); Sec. 4411 (imposing $50 occupational tax on each individual engaged in wagering business); Sec. 4402(3) (exempting state-operated gambling operations, such as lotteries).

In this lawsuit two Native American Indian Tribes, the Choctaw and Chickasaw Nations, claim that the Gaming Act subsection exempts them from paying those chapter 35 taxes from which States are exempt. Brief for Petitioners 34–36. They rest their claim upon the subsection's explicit parenthetical reference to chapter 35. The Tenth Circuit rejected their claim on the ground that the subsection, despite its parenthetical reference, applies only to Code provisions that concern the "reporting and withholding of taxes." 208 F.3d 871, 883–884 (2000); see also 210 F.3d 389 (2000). The Court of Appeals for the Federal Circuit, however, reached the opposite conclusion. *Little Six, Inc. v. United States*, 210 F.3d 1361, 1366 (2000). We granted certiorari in order to resolve the conflict. We agree with the Tenth Circuit.

II

The Tribes' basic argument rests upon the subsection's explicit reference to "chapter 35" — contained in a parenthetical that refers to four other Internal Revenue Code provisions as well. The subsection's language outside the parenthetical says that the subsection applies to those Internal Revenue Code provisions that concern "reporting and withholding." The other four parenthetical references are to provisions that concern, or at least arguably concern, reporting and withholding. See 26 U.S.C. Sec. 1441 (withholding of taxes for nonresident alien); Sec. 3402(q) (withholding of

*JUSTICE SCALIA and JUSTICE THOMAS join all but Part II-B of this opinion.

taxes from certain gambling winnings); 26 U.S.C. Sec. 6041 (reporting by businesses of payments, including payments of gambling winnings, to others); Sec. 6050I (reporting by businesses of large cash receipts, arguably applicable to certain gambling winnings or receipts).

But what about chapter 35? The Tribes correctly point out that chapter 35 has nothing to do with "reporting and withholding." Brief for Petitioners 28–29. They add that the reference must serve some purpose, and the only purpose that the Tribes can find is that of expanding the scope of the Gaming Act's subsection beyond reporting and withholding provisions — to the tax-imposing provisions that chapter 35 does contain. The Gaming Act therefore must exempt them (like States) from those tax payment requirements. The Tribes add that at least the reference to chapter 35 makes the subsection ambiguous. And they ask us to resolve the ambiguity by applying a special Indian-related interpretative canon, namely, "'statutes are to be construed liberally in favor of the Indians' with ambiguous provisions interpreted to their benefit." Brief for Petitioners 13 (quoting *Montana v. Blackfeet Tribe*, 471 U.S. 759, 766 (1985)).

We cannot accept the Tribes' claim. We agree with the Tribes that rejecting their argument reduces the phrase "(including . . . chapter 35) . . ." to surplusage. Nonetheless we can find no other reasonable reading of the statute.

A

The language of the statute is too strong to bend as the Tribes would wish — *i.e.*, so that it gives the chapter 35 reference independent operative effect. For one thing, the language outside the parenthetical is unambiguous. It says without qualification that the subsection applies to "provisions . . . concerning the reporting and withholding of taxes." And the language inside the parenthetical, prefaced with the word "including," literally says the same. To "include" is to "contain" or "comprise as part of a whole." Webster's Ninth New Collegiate Dictionary 609 (1985). In this instance, that which "contains" the parenthetical references — the "whole" of which the references are "parts" — is the phrase "provisions . . . concerning the reporting and withholding of taxes. . . ." The use of parentheses emphasizes the fact that that which is within is meant simply to be illustrative, hence redundant — a circumstance underscored by the lack of any suggestion that Congress intended the illustrative list to be complete. Cf. 26 U.S.C. Sec. 3406 (backup withholding provision not mentioned in parenthetical).

Nor can one give the chapter 35 reference independent operative effect without seriously rewriting the language of the rest of the statute. One would have to read the word "including" to mean what it does not mean, namely, "including . . . and." One would have to read the statute as if, for example, it placed "chapter 35" outside the parenthetical and said "provisions of the . . . Code *including chapter 35 and also provisions* . . . concerning the reporting and withholding of taxes. . . ." Or, one would have to read the language as if it said "provisions of the . . . Code . . . concerning *the taxation and* the reporting and withholding of taxes. . . ." We mention this latter possibility because the congressional bill that became the law before us once did read that way. But when the bill left committee, it contained not the emphasized words ("the taxation and") but the cross-reference to chapter 35.

We recognize the Tribes' claim (made here for the first time) that one could avoid rewriting the statute by reading the language outside the parenthetical as if it referred to two kinds of "provisions of the . . . Code": first those "concerning the reporting and withholding of taxes with respect to the winnings from gaming," and, second, those "concerning . . . wagering operations." See Reply Brief for Petitioners 8–10. The subsection's grammar literally permits this reading. But that reading, even if ultimately comprehensible, is far too convoluted to believe Congress intended it. Nor is there any reason to think Congress intended to sweep within the subsection's scope every Internal Revenue Code provision concerning wagering — a result that this unnatural reading would accomplish.

The subject matter at issue also counsels against accepting the Tribes' interpretation. That subject matter is tax exemption. When Congress enacts a tax exemption, it ordinarily does so explicitly. We can find no comparable instance in which Congress legislated an exemption through an inexplicit numerical cross-reference — especially a cross-reference that might easily escape notice.

As we have said, the more plausible role for the parenthetical to play in this subsection is that of providing an illustrative list of examples. So considered, "chapter 35" is simply a bad example — an example that Congress included inadvertently. The presence of a bad example in a statute does not warrant rewriting the remainder of the statute's language. Nor does it necessarily mean that the statute is ambiguous, *i.e.*, "capable of being understood in two or more possible senses or ways." Webster's Ninth New Collegiate Dictionary 77 (1985). Indeed, in ordinary life, we would understand an analogous instruction — say, "Test drive some cars, including Plymouth, Nissan, Chevrolet, Ford, and Kitchenaid" — not as creating ambiguity, but as reflecting a mistake. Here too, in context, common sense suggests that the cross-reference is simply a drafting mistake, a failure to delete an inappropriate cross-reference in the bill that Congress later enacted into law. Cf. *Little Six, Inc. v. United States*, 229 F.3d 1383, 1385 (CA Fed. 2000) (Dyk, J., dissenting from denial of rehearing en banc) ("The language of the provision has all the earmarks of a simple mistake in legislative drafting").

B

The Gaming Act's legislative history on balance supports our conclusion. The subsection as it appeared in the original Senate bill applied both to taxation and to reporting and withholding. It read as follows:

> "Provisions of the Internal Revenue Code . . . concerning *the taxation and* the reporting and withholding of taxes with respect to gambling or wagering operations shall apply to Indian gaming operations . . . the same as they apply to State operations," S. 555, 100th Cong., 1st Sess., 37 (1987).

With the "taxation" language present, it would have made sense to include chapter 35, which concerns taxation, in a parenthetical that included other provisions that concern reporting and withholding. But the Senate committee deleted the taxation language. Why did it permit the

cross-reference to chapter 35 to remain? Committee documents do not say.

The Tribes argue that the committee intentionally left it in the statute in order to serve as a *substitute* for the word "taxation." An *amicus* tries to support this view by pointing to a tribal representative's testimony that certain Tribes were "opposed to any indication where Internal Revenue would be collecting taxes from the tribal bingo operations." Hearings on S. 555 and S. 1303 before the Senate Select Committee on Indian Affairs, 100th Cong., 1st Sess., 109 (1987) (statement of Lionel John, Executive Director of United South and Eastern Tribes). Other Tribes thought the "taxation" language too "vague," preferring a clear statement "that the Internal Revenue Service is not being granted authority to tax tribes." *Id.*, at 433, 435 (statement of Charles W. Blackwell, Representative of the American Indian Tribal Government and Policy Consultants, Inc.).

Substitution of "chapter 35" for the word "taxation," however, could not have served the tribal witnesses purposes, for doing so took from the bill the very words that made clear the tribes would *not* be taxed and substituted language that made it more likely they would be taxed. Nor can we believe that anyone seeking to grant a tax exemption would intentionally substitute a confusion-generating numerical cross-reference, see Part A, *supra*, for pre-existing language that unambiguously carried out that objective. It is far easier to believe that the drafters, having included the entire parenthetical while the word "taxation" was still part of the bill, unintentionally failed to remove what had become a superfluous numerical cross-reference—particularly since the tax-knowledgeable Senate Finance Committee never received the opportunity to examine the bill. Cf. S. Doc. No. 100–1, Senate Manual, 30 (1987) (proposed legislation concerning revenue measures shall be referred to the Committee on Finance).

Finally, the Tribes point to a letter written by one of the Gaming Act's authors, stating that "by including reference to Chapter 35," Congress intended "that the tax treatment of wagers conducted by tribal governments be the same as that for wagers conducted by state governments under Chapter 35." App. to Pet. for Cert. 113a. This letter, however, was written after the event. It expresses the views of only one member of the committee. And it makes no effort to explain the critical legislative circumstance, namely, the elimination of the word "taxation" from the bill. The letter may express the Senator's interpretive preference, but that preference cannot overcome the language of the statute and the related considerations we have discussed. See *Heintz v. Jenkins*, 514 U.S. 291, 298 (1995) (A "statement [made] not during the legislative process, but *after* the statute became law . . . is not a statement upon which other legislators might have relied in voting for or against the Act, but it simply represents the views of one informed person on an issue about which others may (or may not) have thought differently"). Cf. *New York Telephone Co. v. New York State Dept. of Labor*, 440 U.S. 519, 564, n. 18 (1979) (Powell, J., dissenting) ("The comments . . . of a single Congressman, delivered long after the original passage of the [act at issue], are of no aid in determining congressional intent . . .").

In sum, to adopt the Tribes' interpretation would read back into the Act the very word "taxation" that the Senate committee deleted. We ordinarily will not assume that Congress intended "'to enact statutory language that it has earlier discarded in favor of other language.'" *INS v. Cardoza-Fonseca*, 480 U.S. 421, 443 (1987) (quoting *Nachman Corp. v. Pension Benefit Guaranty Corporation*, 446 U.S. 359, 392–393 (1980)); *Gulf Oil Corp. v. Copp Paving Co.*, 419 U.S. 186, 200 (1974) (same); *Mescalero Apache Tribe v. Jones*, 411 U.S. 145, 157 (1973) (same). There is no special reason for doing so here.

C

The Tribes point to canons of interpretation that favor their position. The Court has often said that "'every clause and word of a statute'" should, "'if possible,'" be given "'effect.'" *United States v. Menasche*, 348 U.S. 528, 538–539 (1955) (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883)). The Tribes point out that our interpretation deprives the words "chapter 35" of any effect. The Court has also said that "statutes are to be construed liberally in favor of the Indians with ambiguous provisions interpreted to their benefit." *Montana v. Blackfeet Tribe*, 471 U.S. at 766; *South Carolina v. Catawba Tribe, Inc.*, 476 U.S. 498, 520 (1986) (Blackmun, J., dissenting). The Tribes point out that our interpretation is not to the Indians' benefit.

Nonetheless, these canons do not determine how to read this statute. For one thing, canons are not mandatory rules. They are guides that "need not be conclusive." *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 115 (2001). They are designed to help judges determine the Legislature's intent as embodied in particular statutory language. And other circumstances evidencing congressional intent can overcome their force. In this instance, to accept as conclusive the canons on which the Tribes rely would produce an interpretation that we conclude would conflict with the intent embodied in the statute Congress wrote. Cf. *Choteau v. Burnet*, 283 U.S. 691 (1931) (upholding taxation where congressional intent reasonably clear); *Superintendent of Five Civilized Tribes v. Commissioner*, 295 U.S. 418 (1935) (same); *Mescalero Apache Tribe v. Jones, supra* (same). In light of the considerations discussed earlier, we cannot say that the statute is "fairly capable" of two interpretations, cf. *Montana v. Blackfeet Tribe, supra*, at 766, nor that the Tribes' interpretation is fairly "possible."

Specific canons "are often countered . . . by some maxim pointing in a different direction." *Circuit City Stores, Inc. v. Adams, supra*, at 115. The canon requiring a court to give effect to each word "*if possible*" is sometimes offset by the canon that permits a court to reject words "as surplusage" if "inadvertently inserted or if repugnant to the rest of the statute . . . ." K. Llewellyn, The Common Law Tradition 525 (1960). And the latter canon has particular force here where the surplus words consist simply of a numerical cross-reference in a parenthetical. Cf. *Cabell Huntington Hospital, Inc. v. Shalala*, 101 F.3d 984, 990 (CA4 1996) ("A parenthetical is, after all, a parenthetical, and it cannot be used to overcome the operative terms of the statute").

Moreover, the canon that assumes Congress intends its statutes to benefit the tribes is offset by the canon that warns us against interpreting federal statutes as

providing tax exemptions unless those exemptions are clearly expressed. See *United States v. Wells Fargo Bank*, 485 U.S. 351, 354 (1988) ("[E]xemptions from taxation . . . must be unambiguously proved"); *Squire v. Capoeman*, 351 U.S. 1, 6 (1956) ("[T]o be valid, exemptions to tax laws should be clearly expressed"); *United States Trust Co. v. Helvering*, 307 U.S. 57, 60 (1939) ("Exemptions from taxation do not rest upon implication"). Nor can one say that the pro-Indian canon is inevitably stronger — particularly where the interpretation of a congressional statute, rather than an Indian treaty, is at issue. Cf. *post*, at 7. This Court's earlier cases are too individualized, involving too many different kinds of legal circumstances, to warrant any such assessment about the two canons' relative strength. Compare, *e.g.*, *Choate v. Trapp*, 224 U.S. 665, 675–676 (1912) (interpreting statement in treaty-related Indian land patents that land is "nontaxable" as creating property right invalidating later congressional effort to tax); *Squire, supra*, at 3 (Indian canon offsetting tax canon when related statutory provision and history make clear that language freeing Indian land "'of all charge or incumbrance whatsoever'" includes tax); *McClanahan v. Arizona Tax Comm'n*, 411 U.S. 164, 174 (1973) (state tax violates principle of Indian sovereignty embodied in treaty), with *Mescalero, supra* (relying on tax canon to find Indians taxable); *Choteau, supra* language makes clear no exemption); *Five Tribes, supra* (same).

Consequently, the canons here cannot make the difference for which the Tribes argue. We conclude that the judgments of the Tenth Circuit must be affirmed.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 00–507

CHICKASAW NATION, PETITIONER *v.* UNITED STATES

CHOCTAW NATION OF OKLAHOMA, PETITIONER *v.* UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

November 27, 2001

JUSTICE O'CONNOR, with whom JUSTICE SOUTER joins, dissenting.

The Court today holds that 25 U.S.C. Sec. 2719(d) (1994 ed.) clearly and unambiguously fails to give Indian Nations (Nations) the exemption from federal wagering excise and related occupational taxes enjoyed by the States. Because I believe Sec. 2719(d) is subject to more than one interpretation, and because "statutes are to be construed liberally in favor of the Indians, with ambiguous provisions interpreted to their benefit," *Montana v. Blackfeet Tribe*, 471 U.S. 759, 766 (1985), I respectfully dissent.

I

I agree with the Court that Sec. 2719(d) incorporates an error in drafting. I disagree, however, that the section's reference to chapter 35 is necessarily that error.

As originally proposed in the Senate, the bill that became the Indian Gaming Regulatory Act (IGRA) would have applied all gambling and wagering-related sections of the Internal Revenue Code to the Nations in the same manner as the States:

> "Provisions of the Internal Revenue Code of 1986, concerning the taxation and the reporting and withholding of taxes with respect to gambling or wagering operations shall apply to Indian gaming operations conducted pursuant to this Act the same as they apply to State operations." S. 555, 100th Cong., 1st Sess., 37 (1987).

The Senate Indian Affairs Committee altered the language of this bill in two contradictory ways. It restricted the applicable Code sections to those relating to the "reporting and withholding of taxes with respect to the winnings" from gaming operations. 25 U.S.C. Sec. 2719(d). It also added a parenthetical listing specific Code sections to be applied to the Nations in the same manner as the States, including chapter 35, a Code provision that relates to gambling operations generally, but not to the reporting and withholding of gambling winnings. *Ibid.*

One of these two changes must have been made in error. There is no reason to assume, however, that it must have been the latter. It is equally likely that Congress intended Sec. 2719(d) to apply chapter 35 to the Nations, but adopted too restrictive a general characterization of the applicable sections.

The Court can do no more than speculate that the bill's drafters included the parenthetical while the original restriction was in place and failed to remove it when that restriction was altered. See *ante*, at 7. Both the inclusion of the parenthetical and the alteration of the restriction occurred in the Senate committee, S. Rep. No. 100–446 (1988), and there is no way to determine the order in which they were adopted. If the parenthetical was added after the restriction, one could just as easily characterize the *restriction* as an unintentional holdover from a previous version of the bill.

True, reading the statute to grant the Nations the exemption requires the section's reference to the "reporting and withholding of taxes with respect to the winnings" from gaming operations to sustain a meaning the words themselves cannot bear. But the Court's reading of the statute fares no better: It requires excising from Sec. 2719(d) Congress' explicit reference to chapter 35. This goes beyond treating statutory language as mere surplusage. See *Potter v. United States*, 155 U.S. 438, 446 (1894) (the presence of statutory language "cannot be regarded as mere surplusage; it means something"); cf. *ante*, at 3. Surplusage is redundant statutory language, *Babbitt v. Sweet Home Chapter, Communities for Great Ore.*, 515 U.S. 687, 697–698 (1995); W. Popkin, Materials on Legislation: Political Language and the Political Process 214 (3d ed. 2001) — the Court's reading negates language that undeniably bears separate meaning. This is not a step to be undertaken lightly.

Both approaches, therefore, require rewriting the statute, see *ante*, at 4. Neither of these rewritings is necessarily more "serious" than the other: At most, each involves doing no more than reversing a change made in committee. Cf. *ante*, at 4–5.

The Court argues that because the reference to chapter 35 occurs in a parenthetical, negating this language does less damage to the statute than concluding that the restrictive language outside the parenthetical is too narrowly drawn. I am aware of no generally accepted canon of statutory construction favoring language outside of parentheses to language within them, see, *e.g.*, W. Eskridge, P. Frickey, & E. Garrett, Legislation and Statutory Interpretation, App. C (2000) (listing canons), nor do I think it wise for the Court to adopt one today. The importance of statutory language depends not on its punctuation, but on its meaning. See *United States Nat. Bank of Ore. v. Independent Ins. Agents of America, Inc.*, 508 U.S. 439, 454 (1993) ("[A] purported plain-meaning analysis based only on punctuation is necessarily incomplete and runs the risk of distorting a statute's true meaning").

The fact that the parenthetical is illustrative does not change the analysis: If Congress' illustration does not match its general description, there is as much reason to question the description as the illustration. Where another general description is possible — and was in fact part of the bill at an earlier stage — Congress' choice of an example that matches the earlier description is at least ambiguous. Moreover, as Sec. 2719(d)'s parenthetical specifically lists statutory sections to be applied to the Nations, one might in fact conclude that the doctrine that the specific governs the general, *Crawford Fitting Co. v. J. T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987), makes this specific parenthetical even more significant than the general restriction that follows.

Nor is negating Congress' clear reference to chapter 35 required by the policy behind the statute. If anything, congressional policy weighs in favor of the Nations. Congress' central purpose in enacting IGRA was "to provide a statutory basis for the operation of gaming by Indian tribes as a means of promoting tribal economic development, self-sufficiency, and strong tribal governments." Sec. 2702(1). Exempting Nations from federal gaming taxation in the same manner as States preserves the Nations' sovereignty and avoids giving state gaming a competitive advantage that would interfere with the Nations' ability to raise revenue in this manner.

II

Because nothing in the text, legislative history, or underlying policies of Sec. 2719(d) clearly resolves the contradiction inherent in the section, it is appropriate to turn to canons of statutory construction. The Nations urge the Court to rely upon the Indian canon, that "statutes are to be construed liberally in favor of the Indians, with ambiguous provisions interpreted to their benefit," *Montana v. Blackfeet Tribe*, 471 U.S., at 766, as a basis for deciding that the error in Sec. 2719(d) lies in the restriction of the subclass, not in the specific listing of chapter 35. "[R]ooted in the unique trust relationship between the United States and the Indians," *County of Oneida v. Oneida Indian Nation of N.Y.*, 470 U.S. 226, 247 (1985), the Indian canon presumes congressional intent to assist its wards to overcome the disadvantages our country has placed upon them. Consistent with this purpose, the Indian canon applies to statutes as well as treaties: The form of the enactment does not change the presumption that Congress generally intends to benefit the Nations. *Montana v. Blackfeet Tribe, supra; County of Yakima v. Confederated Tribes and Bands of Yakima Nation*, 502 U.S. 251 (1992). In this case, because Congress has chosen gaming as a means of enabling the Nations to achieve self-sufficiency, the Indian canon rightly dictates that Congress should be presumed to have intended the Nations to receive more, rather than less, revenue from this enterprise.

Of course, the Indian canon is not the only canon with potential applicability in this case. Also relevant is the taxation principle, that exemptions from taxation must be clearly expressed. *United States Trust Co. v. Helvering*, 307 U.S. 57, 60 (1939); see also *ante*, at 10. These canons pull in opposite directions, the former favoring the Nations' preferred reading, and the latter favoring the Government's.

This Court has repeatedly held that, when these two canons conflict, the Indian canon predominates. In *Choate v. Trapp*, 224 U.S. 665 (1912), a State attempted to rely on the taxation principle to argue that a treaty provision making land granted to Indians nontaxable was merely a bounty, capable of being withdrawn at any time. The Court acknowledged the taxation principle, responding:

> "But in the Government's dealings with the Indians, the rule is exactly the contrary. The construction, instead of being strict, is liberal; doubtful expressions, instead of being resolved in favor of the United States, are to be resolved in favor of [Indian nations.] *Id.*, at 674–675.

In *Squire v. Capoeman*, 351 U.S. 1, 3 (1956), the Federal Government had conveyed land to the Nations "'free of all charge or encumbrance whatsoever.'" Although this phrase did not expressly mention nontaxability, the Court held that the language "might well be sufficient to include taxation," *id.*, at 7. Invoking the Indian canon, *id.*, at 6–7, we found the Nations exempt.

Likewise, in *McClanahan v. Arizona Tax Comm'n*, 411 U.S. 164 (1973), this Court inferred an exemption from state taxation of property inside reservations from a treaty reserving lands for the exclusive use and occupancy of the Nations. In doing so, the Court noted that: "It is true, of course, that exemptions from tax laws should, as a general rule, be clearly expressed. But we have in the past construed language far more ambiguous than this as providing a tax exemption for Indians." *Id.*, at 176 (citing *Squire*, *supra*, at 6).

As the purpose behind the Indian canon is the same regardless of the form of enactment, *supra*, at 5, there is no reason to alter the Indian canon's relative strength where a statute rather than a treaty is involved. Cf. *ante*, at 10. The primacy of the Indian canon over the taxation principle should not be surprising, as this Court has also held that the general presumption supporting the legality of executive action must yield to the Indian canon, a "counterpresumption specific" to Indians. *Minnesota v. Mille Lacs Band of Chippewa Indians*, 526 U.S. 172, 194, n. 5 (1999).

This Court has failed to apply the Indian canon to extend tax exemptions to the Nations only when nothing in the language of the underlying statute or treaty suggests the Nations should be exempted. *The Cherokee Tobacco*, 11 Wall. 616, 618–620 (1871) (finding no exemption for the Nations from language imposing

taxes on certain "'articles produced anywhere within the exterior boundaries of the United States'"); *Choteau v. Burnet*, 283 U.S. 691, 693–694 (1931) (finding no exemption in provisions "subject[ing] the income of 'every individual' to tax," including "income 'from any source whatever'"); *Superintendent of Five Civilized Tribes v. Commissioner*, 295 U.S. 418 (1935) (same); *Mescalero Apache Tribe v. Jones*, 411 U.S. 145, 155 (1973) (refusing to exempt the Nations from taxes on land use income based on language that "[o]n its face . . . exempts land and rights in land, not income derived from its use"). *Mescalero* also went further, suggesting that because of the taxation principle, the Court would refuse to find such an exemption absent "clear statutory guidance." *Id.*, at 156. *Mescalero's* formulation is admittedly in tension with the Court's precedents giving the Indian canon primacy over the taxation principle where statutory language is ambiguous. As *Mescalero* was decided on the same day as one of those very precedents, the unanimous decision in *McClanahan v. Arizona Tax Comm'n*, *supra*, however, it cannot have intended to alter the Court's established practice.

Section 2719(d) provides an even more persuasive case for application of the Indian canon than any of our precedents. Here, the Court is not being asked to create out of vague language a tax exemption not specifically provided for in the statute. Instead, the Nations simply ask the Court to use the Indian canon as a tiebreaker between two equally plausible (or, in this case, equally implausible) constructions of a troubled statute, one which specifically makes chapter 35's tax exemption applicable to the Nations, and one which specifically does not. Breaking interpretive ties is one of the least controversial uses of any canon of statutory construction. See Eskridge, Frickey, & Garrett, Legislation and Statutory Interpretation, at 341 ("The weakest kind of substantive canon operates merely as a *tiebreaker* at the end of the interpretive analysis").

Faced with the unhappy choice of determining which part of a flawed statutory section is in error, I would thus rely upon the long-established Indian canon of construction and adopt the reading most favorable to the Nations.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page 716.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2002. See Rev. Rul. 2002–17, page716.

EMBASSY OF THE
UNITED STATES OF AMERICA

No. 2001-055

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Republic of Ghana, and has the honor to propose that the two governments conclude an agreement to exempt from income tax, on a reciprocal basis, certain income derived from the international operation of a ship or ships and aircraft as follows:

The Government of the United States of America, in accordance with Sections 872(b) and 883(a) of the U.S. Internal Revenue Code of 1986, agrees to exempt from U.S. federal income tax gross income derived from the international operation of a ship or ships or aircraft by individuals who are residents of Ghana (other than U.S. citizens or residents) and corporations that are organized in Ghana, in each case, that are engaged in the international operation of a ship or ships or aircraft. This exemption shall be granted on the basis of equivalent exemptions granted by Ghana to individual residents of the United States and to corporations organized in the United States.

In the case of a Ghanaian corporation, the exemption shall apply only if the corporation meets the ownership or public trading requirements of U.S. law. For purposes of such ownership requirements, the Government of Ghana shall be treated as an individual resident of Ghana.

Gross income derived from the international operation of a ship or ships or aircraft includes:

(i) Income from the rental on a full (time or voyage) basis of a ship or ships or aircraft used in international transport;

(ii) Income from the rental on a bareboat basis of a ship or ships or aircraft used in international transport;

(iii) Income from the rental of containers and related equipment used in international transport that is incidental to income from the international operation of a ship or ships or aircraft;

(iv) Gains from the sale or other alienation of a ship or ships or aircraft used in international transport; and

(v) Income derived by an individual or corporation otherwise engaged in the international operation of a ship or ships or aircraft from active participation in a pool, an alliance, joint venture, international operating agency, or other venture,

that is itself engaged in the international operation of a ship or ships or aircraft.

The Embassy, on behalf of the Government of the United States of America, proposes that if the foregoing is acceptable to the Government of Ghana, this note and the Ministry's reply note shall constitute an agreement between the two Governments, which shall enter into force on the date of the Ministry's reply note and shall have effect with respect to taxable years beginning on or after January 1, 2001 It shall remain in force until terminated by either Government giving written notice to the other Government through diplomatic channels.

The Embassy of the United States of America avails itself of this opportunity to renew to the Ministry of Foreign Affairs of the Government of Ghana the assurances of its highest consideration.

Enclosure:
1. Draft reply note

Embassy of the United States of America

Accra, April 24, 2001

EMBASSY OF THE UNITED STATES OF AMERICA
ACCRA

SCR.TI/TA/USA

REPUBLIC OF GHANA

MINISTRY OF FOREIGN AFFAIRS

The Ministry of Foreign Affairs of the Republic of Ghana presents its compliments to the Embassy of the United States of America and has the honour to acknowledge with thanks the receipt of Note No. 2001-005 of April 24, 2001 proposing an agreement to exempt from Ghanaian tax gross income derived from the international operation of a ship or ships or aircraft by individual residents of the United States and by corporations organized in the United States, in each case, that are engaged in the international operation of a ship or ships or aircraft. This exemption shall be granted on the basis of equivalent exemptions granted by the United States to individuals who are residents of Ghana (other than U.S. citizens or residents) and to corporations that are organized in Ghana.

The terms of the agreement are as follows:

The Government of Ghana agrees to exempt from Ghanaian tax gross income derived from the international operations of a ship or ships or aircraft by individuals who are residents of the United States and corporations that are organized in the United States, in each case, that are engaged in the international operation of a ship or ships or aircraft. This exemption is granted on the basis of equivalent exemptions granted by the United States under the terms of the Embassy's note of April 24, 2001.

Gross income derived from the international operation of a ship or ships or aircraft includes:

- Income from the rental on a full (time or voyage) basis of a ship or ships or aircraft used in international transport;

- Income from the rental on a bareboat basis of a ship or ships or aircraft used in international transport;

- Income from the rental of containers and related equipment used in international transport that is incidental to income from the international operation of a ship or ships or aircraft;

- Gains from the sale or other alienation of a ship or ships or aircraft used in international transport; and

- Income derived by an individual or corporation otherwise engaged in the international operation of a ship or ships or aircraft from active participation in a pool, an alliance, joint venture, international operating agency, or other venture, that is itself engaged in the international operation of a ship or ships or aircraft.

The Ministry of Foreign Affairs of the Republic of Ghana confirms that the Government of Ghana accepts the proposal contained in the Embassy's Note No. 2001-055 and that the Embassy's note and this note in reply constitute an agreement between the two Governments, which shall enter into force on the date of this note and shall have effect with respect to taxable years beginning on or after January 1, 2001. It shall remain in force until terminated by either Government giving written notice to the other Government through diplomatic channels.

The Ministry of Foreign Affairs of the Government of Ghana avails itself of this opportunity to renew to the Embassy of the United States the assurances of its highest consideration.

Accra, 12th November, 2001

THE EMBASSY OF THE
UNITED STATES OF AMERICA,
ACCRA.

Part III. Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Inflated Basis

Notice 2002–21

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is used by taxpayers to generate tax losses. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

In general, the transaction involves the use of a loan assumption agreement to claim an inflated basis in assets acquired from another party. This inflated basis is claimed as a result of a transfer of assets in which a U.S. taxpayer (Taxpayer) becomes jointly and severally liable on indebtedness of the transferor of the assets (Transferor), with the indebtedness having a stated principal amount substantially in excess of the fair market value of the assets transferred. Transferor may not be subject to U.S. tax or otherwise may be indifferent to the federal income tax consequences of the transaction.

In one variation of the transaction, Transferor borrows money from a lender (Lender) on a long term basis such as 30 years (the "Loan"). The amount borrowed may be in a foreign currency. Interest is payable at regular intervals, and principal is due at maturity. The Loan may permit prepayment. The Loan is made with full recourse to Transferor.

Transferor uses the proceeds to purchase assets (the "Assets"), such as short-term deposits, government bonds, or high-grade corporate debt, which may be denominated in a foreign currency. The Assets serve as collateral for the Loan pursuant to a loan agreement. As each interest payment becomes due, the collateral is used to satisfy such payments. Upon maturity or earlier payment, the Loan is satisfied, by its terms, first from the collateral, and only then against Transferor (or Transferor and any party that has assumed the liability as a joint and several obligor) to satisfy any shortfall.

Pursuant to a separate agreement between Transferor and Taxpayer, Transferor transfers a portion of the Assets to Taxpayer in consideration for Taxpayer's agreement to pay a portion of the Loan and become jointly and severally liable to Lender as a co-obligor on the Loan. The fair market value of the Assets transferred to Taxpayer (the "Conveyed Assets") equals the present value of the Loan's principal payment at maturity, determined by using a market rate of interest. Thus, the fair market value of the Conveyed Assets is substantially less than the Loan's stated principal amount. Taxpayer provides substitute collateral for the Loan, equal in value to the Conveyed Assets. The remainder of the Assets owned by Transferor continue to serve as collateral for the Loan.

Also pursuant to the agreement between Transferor and Taxpayer, Transferor agrees to make all interest payments on the Loan, and Taxpayer agrees to pay the principal due at maturity. The co-obligors and Lender anticipate that the collateral will be substantially (if not entirely) sufficient to repay the Loan.

Taxpayer subsequently disposes of the Conveyed Assets for their fair market value. Taxpayer claims that, as a result of its assumption of joint and several liability on the Loan, the entire principal amount of the Loan is included in Taxpayer's basis in the Conveyed Assets. As a result, Taxpayer claims a loss for federal income tax purposes in an amount equal to the excess of the stated principal amount of the Loan over the fair market value of the Conveyed Assets. If the Conveyed Assets are nonfunctional currency, Taxpayer claims an ordinary loss.

ANALYSIS

Section 1012 of the Internal Revenue Code provides that the basis of property is equal to the cost of the property. Section 1.1012–1(a) of the Income Tax Regulations defines "cost" to mean the "amount paid" for the property in cash or other property. Under general tax law principles, the amount paid for property generally includes the amount of the seller's liabilities assumed by the buyer. *Commissioner v. Oxford Paper Co.*, 194 F.2d 190 (2d. Cir. 1952). The inclusion of liabilities in basis by a buyer, however, is predicated on the assumption that the liabilities will be paid in full by the buyer. *See Commissioner v. Tufts*, 461 U.S. 300, 308 (1983), 1983–1 C.B. 120, 123.

In appropriate cases, the courts have rejected attempts to assign an inflated basis to property and have limited the basis of property to its fair market value. For example, the basis of property acquired with the issuance or assumption of recourse indebtedness has been limited to the acquired property's fair market value where "a transaction is not conducted at arm's-length by two economically self-interested parties or where a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value." *Lemmen v. Commissioner*, 77 T.C. 1326, 1348 (1981) (citing *Bixby v. Commissioner*, 58 T.C. 757, 776 (1972)); *Webber v. Commissioner*, T.C. Memo. 1983–633, *aff'd*, 790 F.2d 1463 (9th Cir. 1986). *See also Majestic Securities Corp. v. Commissioner*, 42 B.T.A. 698, 701 (1940), *aff'd*, 120 F.2d 12 (8th Cir. 1941) ("The general rule that the price paid is the basis for determining gain or loss on future disposition presupposes a normal business transaction.")

Other cases have limited the portion of an assumed indebtedness that may be taken into account for federal income tax purposes. For example, where two or more persons are liable on the same indebtedness, or hold separate properties subject to the same indebtedness, the amount taken into account for federal income tax purposes by each person generally is based on all the facts and circumstances, including the economic realities of the situation and the parties' expectations as to how the liabilities will be paid. *See Maher v. United States*, No. 16253–1 (W.D. Mo. 1969) (property was not in substance "subject to" liability where lender was not actually relying on

property as collateral); *Maher v. Commissioner*, 469 F.2d 225 (8th Cir. 1972) (corporation's assumption of primary liability on shareholder's indebtedness becomes taxable dividend only as corporation makes payments as promised); *Snowa v. Commissioner*, T.C. Memo 1995–336, *rev'd on other grounds*, 123 F.3d 190 (4th Cir. 1997) (co-obligor's cost of a new residence included only her ratable share of the liability due to state law's right of contribution).

Under the facts and circumstances of the transaction described in this Notice, as a matter of economic reality, the parties will bear responsibility for repayment of the Loan in accordance with their relative ownership of the Assets immediately after the transfer from Transferor to Taxpayer. Accordingly, the Service and the Treasury believe that Taxpayer's basis in the Conveyed Assets is equal to the fair market value of such assets upon their acquisition by Taxpayer. The losses purportedly resulting from the transaction described in this Notice (or substantially similar to the transaction described in this Notice) are not allowable to the extent Taxpayer derives a tax benefit that is attributable to a basis in excess of the fair market value of the Conveyed Assets. The purported tax benefits from these transactions also may be subject to challenge under other provisions of the Code and regulations, including but not limited to § 988 and, in the case of individuals, §§ 165(c)(2) and 465.

In addition, the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice 2002–21 are identified as "listed transactions" for the purposes of §§ 1.6011–4T(b)(2) of the Temporary Income Tax Regulations and 301.6111–2T(b)(2) of the Temporary Procedure and Administrative Regulations. See also § 301.6112–1T, A–4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111–2T and 301.6112–1T, A–4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111–1T and 301.6112–1T, A–3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a), and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this Notice. These taxpayers are advised to take prompt action to file amended returns.

The principal author of this Notice is Christina A. Morrison of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this Notice, contact Ms. Morrison at (202) 622–3950 (not a toll-free call).

Request for Comments on Items for 2002–2003 Published Guidance Priority List

Notice 2002–22

The Department of Treasury and Internal Revenue Service request public comment about items that should be included in the Guidance Priority List for 2002–2003.

IRS and Treasury's Office of Tax Policy use the Guidance Priority List ("Priority List") each year to identify and prioritize the tax issues that should be addressed through regulations, rulings, and other published administrative guidance. The Priority List will set forth guidance Treasury and the IRS intend to issue from July 1, 2002, through June 30, 2003. Public input is invited as part of the process of formulating the Priority List to ensure that the agencies' resources focus on the guidance items that are most important to taxpayers and tax administration.

As Treasury and the IRS draft guidance and consider suggestions for guidance, we will focus on providing needed guidance on a timely basis and consider the following questions:

1. Whether the guidance is consistent with the letter and the intent of the statutory language.
2. Whether the guidance is easily understood and applied by taxpayers.
3. Whether the guidance is enforceable on a uniform basis by the IRS.
4. Whether the guidance provides bright-line rules and resolves issues rather than raises issues.
5. Whether the guidance reduces controversy and lessens the burden on taxpayer and IRS resources.

No particular format is required for comments submitted in response to this Notice. However, it will be helpful for comments both to briefly describe the item that is recommended for inclusion on the Priority List and to explain why there is a need for guidance. In addition, comments may present an analysis of how the issue should be resolved.

Please submit all comments by April 30, 2002. Written comments should be sent to:

Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–22)
Room 5226
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered between the hours of 8 a.m. and 5 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–22)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, comments may be submitted electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2002–22" in the subject line. All comments will be available for public inspection and copying in their entirety.

For further information regarding this notice, contact Brenda Wilson of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4800 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, § 911, 1.911–1)

Rev. Proc. 2002–20

SECTION 1. PURPOSE

01. This revenue procedure provides information to any individual who failed to meet the eligibility requirements of § 911(d)(1) of the Internal Revenue Code because adverse conditions in a foreign country precluded the individual from meeting those requirements for taxable year 2001.

02. The Internal Revenue Service has previously listed countries for which the eligibility requirements of § 911(d)(1) of the Code are waived under § 911(d)(4) because of adverse conditions in those countries on and after the date stated. See Rev. Proc. 2001–27 (2001–19 I.R.B. 1155), Rev. Proc. 2000–14 (2000–1 C.B. 960), and Rev. Proc. 99–20 (1999–1 C.B. 872) . This revenue procedure lists the country added to the list in 2001, for which the eligibility requirements of § 911(d)(1) are waived. Rev. Proc. 2001–27, Rev. Proc. 2000–14, and Rev. Proc. 99–20 remain in full force and effect.

SECTION 2. BACKGROUND

01. Section 911(a) of the Code allows a "qualified individual," as defined in § 911(d)(1), to exclude foreign earned income and housing cost amounts from gross income. Section 911(c)(3) of the Code allows a qualified individual to deduct housing cost amounts from gross income.

02. Section 911(d)(1) of the Code defines the term "qualified individual" as an individual whose tax home is in a foreign country and who is (A) a citizen of the United States and establishes to the satisfaction of the Secretary of the Treasury that the individual has been a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (B) a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.

03. Section 911(d)(4) of the Code provides an exception to the eligibility requirements of § 911(d)(1). An individual will be treated as a qualified individual with respect to a period in which the individual was a *bona fide* resident of, or was present in, a foreign country if the individual left the country during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business. An individual must establish that but for those conditions the individual could reasonably have been expected to meet the eligibility requirements.

04. For 2001, the Secretary of the Treasury in consultation with the Secretary of State, has determined that war, civil unrest, or similar adverse conditions that precluded the normal conduct of business existed in the following country beginning on the specified date:

	Date of Departure
Country	*On or After*
Macedonia	July 27, 2001

05. Accordingly, for purposes of § 911 of the Code, an individual who left Macedonia on or after July 27, 2001, shall be treated for 2001 as a qualified individual with respect to the period during which that individual was present in, or was a *bona fide* resident of Macedonia, if the individual establishes a reasonable expectation of meeting the requirements of § 911(d) but for those conditions.

06. To qualify for relief under § 911(d)(4) of the Code, an individual must have established residency on or prior to July 27, 2001, or have been physically present in Macedonia on July 27, 2001, the date that the Secretary of the Treasury determined that individuals were required to leave the foreign country. Individuals who establish residency or are first physically present in Macedonia after July 27, 2001, shall not be treated as qualified individuals under § 911(d)(4) of the Code for taxable year 2001.

07. In order to assist those individuals who are filing prior year or amended tax returns, the Internal Revenue Service is republishing the countries listed for tax years 1998, 1999, and 2000, for which the eligibility requirements of § 911(d)(1) of the Code are waived under § 911(d)(4):

Tax Year 1998 —

	Date of Departure
Country	*On or After*
Albania	August 14, 1998
Democratic Republic of the Congo	August 5, 1998
Eritrea	June 5, 1998
Guinea-Bissau	June 10, 1998
Indonesia	May 15, 1998
Pakistan	August 16, 1998
Sierra Leone	December 23, 1998
Serbia-Montenegro	October 11, 1998

Tax Year 1999 —

	Date of Departure
Country	*On or After*
Eritrea	February 12, 1999
Ethiopia	February 12, 1999
Serbia-Montenegro	March 20, 1999

Tax Year 2000 —

	Date of Departure
Country	*On or After*
Eritrea	May 19, 2000

SECTION 3. INQUIRIES

A taxpayer who needs assistance on how to claim this exclusion, or on how to file an amended return, should contact a local IRS Office or, for a taxpayer residing or traveling outside the United States, the nearest overseas IRS office.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2001–27 (2001–19 I.R.B. 1155) is supplemented.

DRAFTING INFORMATION

The principal author of this revenue procedure is Kate Y. Hwa of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure contact Ms. Hwa at (202) 622–3840 (not a toll-free call).

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26 CFR 601.201: Rulings and determination letters. (Also Part I, §§ 267, 511, 512, 707, 761, 856, 1031, 1361; 1.761–1, 1.761–2; 301.7701–1, 301.7701–2, 301.7701–3, 301.7701–4.)

Rev. Proc. 2002–22

SECTION 1. PURPOSE

This revenue procedure specifies the conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in rental real property (other than a mineral property as defined in section 614) is not an interest in a business entity, within the meaning of § 301.7701–2(a) of the Procedure and Administration Regulations.

This revenue procedure supersedes Rev. Proc. 2000–46 (2000–2 C.B. 438), which provides that the Service will not issue advance rulings or determination letters on the questions of whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under § 1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under § 7701. This revenue procedure also modifies Rev. Proc. 2002–3 (2002–1 I.R.B. 117) by removing these issues from the list of subjects on which the Service will not rule. Requests for advance rulings described in Rev. Proc. 2000–46 that are not covered by this revenue procedure, such as rulings concerning mineral property, will be considered under procedures set forth in Rev. Proc. 2002–1 (2002–1 I.R.B. 1) (or its successor).

SECTION 2. BACKGROUND

Section 301.7701–1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under local law. Section 301.7701–1(a)(2) provides that a joint venture or other contractual arrangement

may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.

Section 301.7701–2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701–3) that is not properly classified as a trust under § 301.7701–4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.

Section 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not a corporation or a trust or estate.

Section 1.761–1(a) of the Income Tax Regulations provides that the term "partnership" means a partnership as determined under §§ 301.7701–1, 301.7701–2, and 301.7701–3.

The central characteristic of a tenancy in common, one of the traditional concurrent estates in land, is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common. 7 Richard R. Powell, Powell on Real Property §§ 50.01–50.07 (Michael Allan Wolf ed., 2000).

Rev. Rul. 75–374 (1975–2 C.B. 261) concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed an agent to manage the apartments on their behalf; the agent collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the agent's activities in providing customary services to the tenants, although imputed to the co-owners, were not sufficiently extensive to cause the co-ownership to be characterized as a partnership. See also Rev. Rul. 79–77 (1979–1 C.B. 448), which did not find a business entity where three individuals transferred ownership of a commercial building subject to a net lease to a trust with the three individuals as beneficiaries.

Where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among the co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in *Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993), seventy-eight investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). *Bergford*, 12 F.3d at 169–170. *Accord Bussing v. Commissioner*, 88 T.C. 449 (1987), *aff'd on reh'g*, 89 T.C. 1050 (1987); *Alhouse v. Commissioner*, T.C. Memo. 1991–652.

Under § 1.761–1(a) and §§ 301.7701–1 through 301.7701–3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. However, as the above authorities demonstrate, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships. *Bergford*, 12 F.3d at 169. Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created. *Bussing*, 88 T.C. at 460. Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes. *Bergford*, 12 F.3d at 169.

SECTION 3. SCOPE

This revenue procedure applies to co-ownership of rental real property (other than mineral interests) (the Property) in an arrangement classified under local law as a tenancy-in-common.

This revenue procedure provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth in this revenue procedure are not intended to be substantive rules and are not to be used for audit purposes.

SECTION 4. GUIDELINES FOR SUBMITTING RULING REQUESTS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the information described in section 5 of this revenue procedure is included in the ruling request and the conditions described in section 6 of this revenue procedure are satisfied. Even if sections 5 and 6 of this revenue procedure are satisfied, however, the Service may decline to issue a ruling under this revenue procedure whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "Property." In such a case, the Service will generally not consider a ruling request under this revenue procedure unless: (1) each co-owner's percentage interest in each parcel is identical to that co-owner's percentage interest in every other parcel, (2) each co-owner's percentage interests in the parcels cannot be separated and traded independently, and (3) the parcels of property are properly viewed as a single business unit. The Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. For example, an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

For purposes of this revenue procedure, the following definitions apply. The term "co-owner" means any person that owns an interest in the Property as a tenant in common. The term "sponsor" means any person who divides a single interest in the Property into multiple co-ownership interests for the purpose of offering those interests for sale. The term "related person" means a person bearing a relationship described in § 267(b) or 707(b)(1), except that in applying § 267(b) or 707(b)(1), the co-ownership will be treated as a partnership and each co-owner will be treated as a partner. The term "disregarded entity" means an entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include qualified REIT subsidiaries (within the meaning of § 856(i)(2)), qualified subchapter S subsidiaries (within the meaning of § 1361(b)(3)(B)), and business entities that have only one owner and do not elect to be classified as corporations. The term "blanket lien" means any mortgage or trust deed that is recorded against the Property as a whole.

SECTION 5. INFORMATION TO BE SUBMITTED

.01 Section 8 of Rev. Proc. 2002–1 outlines general requirements concerning the information to be submitted as part of a ruling request, including advance rulings under this revenue procedure. For example, any ruling request must contain a complete statement of all facts relating to the co-ownership, including those relating to promoting, financing, and managing the Property. Among the information to be included are the items of information specified in this revenue procedure; therefore, the ruling request must provide all items of information and conditions specified below and in section 6 of this revenue procedure, or at least account for all of the items. For example, if a co-ownership arrangement has no brokerage agreement permitted in section 6.12 of this revenue procedure, the ruling request should so state. Furthermore, merely submitting documents and supplementary materials required by section 5.02 of this revenue procedure does not satisfy all of the information requirements contained in section 5.02 of this revenue procedure or in section 8 of Rev. Proc. 2002–1; all material facts in the documents submitted must be explained in the ruling request and may not be merely incorporated by reference. All submitted documents and supplementary materials must contain applicable exhibits, attachments, and amendments. The ruling request must identify and explain any information or documents required in section 5 of this revenue procedure that are not included and any conditions in section 6 of this revenue procedure that are or are not satisfied.

.02 *Required General Information and Copies of Documents and Supplementary Materials.* Generally the following information and copies of documents and materials must be submitted with the ruling request:

(1) The name, taxpayer identification number, and percentage fractional interest in Property of each co-owner;

(2) The name, taxpayer identification number, ownership of, and any relationship among, all persons involved in the acquisition, sale, lease and other use of Property, including the sponsor, lessee, manager, and lender;

(3) A full description of the Property;

(4) A representation that each of the co-owners holds title to the Property (including each of multiple parcels of property treated as a single Property under this revenue procedure) as a tenant in common under local law;

(5) All promotional documents relating to the sale of fractional interests in the Property;

(6) All lending agreements relating to the Property;

(7) All agreements among the co-owners relating to the Property;

(8) Any lease agreement relating to the Property;

(9) Any purchase and sale agreement relating to the Property;

(10) Any property management or brokerage agreement relating to the Property; and

(11) Any other agreement relating to the Property not specified in this section, including agreements relating to any debt secured by the Property (such as guarantees or indemnity agreements) and any call and put options relating to the Property.

SECTION 6. CONDITIONS FOR OBTAINING RULINGS

The Service ordinarily will not consider a request for a ruling under this revenue procedure unless the conditions described below are satisfied. Nevertheless, where the conditions described below are not satisfied, the Service may consider a request for a ruling under this revenue procedure where the facts and

circumstances clearly establish that such a ruling is appropriate.

.01 *Tenancy in Common Ownership*. Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

.02 *Number of Co-Owners*. The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in § 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

.03 *No Treatment of Co-Ownership as an Entity*. The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership.

.04 *Co-Ownership Agreement*. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

.05 *Voting*. The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

.06 *Restrictions on Alienation*. In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person. However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

.07 *Sharing Proceeds and Liabilities upon Sale of Property*. If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

.08 *Proportionate Sharing of Profits and Losses*. Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

.09 *Proportionate Sharing of Debt*. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

.10 *Options*. A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

.11 *No Business Activities*. The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75–374 (1975–2 C.B. 261). Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect

to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

.12 *Management and Brokerage Agreements*. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

.13 *Leasing Agreements*. All leasing arrangements must be *bona fide* leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

.14 *Loan Agreements*. The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.

.15 *Payments to Sponsor*. Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000–46 is superseded. Rev. Proc. 2002–3 is modified by removing sections 5.03 and 5.06.

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Jeanne Sullivan and Deane Burke of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Ms. Sullivan or Mr. Burke at (202) 622–3070 (not a toll-free call).

Part IV. Items of General Interest

Credit for Increasing Research Activities; Correction

Announcement 2002–38

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains corrections to a notice of proposed rulemaking (REG–112991–01, 2002–4 I.R.B. 404) and notice of public hearing relating to the computation of the research credit.

This document was published in the **Federal Register** on December 26, 2001 (66 FR 66362).

FOR FURTHER INFORMATION CONTACT: Lisa J. Shuman (202) 622–3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The proposed regulations that are the subject of these corrections are under sections 41(c) and and 41(d) of the Internal Revenue Code.

Need for Correction

As published, the proposed regulations REG–112991–01, contains errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the proposed regulations REG–112991–01, which is the subject of FR. Doc. 01–31007, is corrected as follows:

§ 1.41–3 [Corrected]

1. On page 66368, column 1, § 1.41–3, paragraph (e), line 3, the language "ending on or after the date December 21" is corrected to read "ending on or after December 26".

§ 1.41–4 [Corrected]

2. On page 66369, column 1, § 1.41–4, paragraph (a)(8), paragraph (i) of *Example 2.*, line 3 from the bottom of paragraph, the language "tests the nozzles to ensure that to ensure that" is corrected to read "tests the nozzles to ensure that".

3. On page 66369, column 1, § 1.41–4, paragraph (a)(8), paragraph (ii) of *Example 2.*, line 2 the language "painting process is a separate business" is corrected to read "painting process relate to a separate business".

4. On page 66369, column 3, § 1.41–4, paragraph (a)(8), paragraph (i) of *Example 6.*, lines 5 through 8 from the bottom of the paragraph, the language "X conducts extensive and complex scientific or laboratory testing to determine if the current model vehicle meets X's requirements." is removed.

5. On page 66370, column 3, § 1.41–4, paragraph (c)(6), line 2 of the paragraph heading, the language "years beginning on or after the" is corrected to read "years beginning on or after".

6. On page 66371, column 2, § 1.41–4, paragraph (c)(6)(iv)(C), line 1 of the column, the language "leased, licensed or otherwise marketed" is corrected to read "leased, licensed, or otherwise marketed".

7. On page 66371, column 2, § 1.41–4, paragraph (c)(6)(vi)(C), line 2 from the bottom of the paragraph, the language "paragraphs (c)(6)(v)(A) and (B) of this" is corrected to read "paragraphs (c)(6)(vi)(A) and (B) of this".

8. On page 66371, column 3, § 1.41–4, paragraph (c)(6)(viii), paragraph (i) of *Example 2.*, line 3, the language "order to create an improved reserve valuation" is corrected to read "order to create the improved reserve valuation".

9. On page 66372, column 3, § 1.41–4, paragraph (c)(6), paragraph (ii) of *Example 7.*, line 1, the language "(ii) *Conclusion.* X's software is software" is corrected to read "(ii) *Conclusion.* X's software is".

10. On page 66375, column 1, § 1.41–4, paragraph (c)(10), paragraph (i) of *Example 6.*, line 1, the language "*Example 6.* (i) *Facts.* X manufacturer and" is corrected to read "*Example 6.* (i) *Facts.* X manufacturers and".

11. On page 66375, column 2, § 1.41–4, paragraph (c)(10), paragraph (1) of *Example 7.* is correctly designated § 1.41–4, paragraph (c)(10), paragraph (i) of *Example 7.*

12. On page 66375, column 2, § 1.41–4, paragraph (c)(10), paragraph (i) of *Example 7.*, line 9, the language "purchases the existing robotic equipment for" is corrected to read "purchases existing robotic equipment for".

13. On page 66375, column 3, § 1.41–4, paragraph (e), line 4, the language "December 26, 2002." is corrected to read "December 26, 2001.".

§ 1.41–8 [Corrected]

14. On page 66375, column 3, § 1.41–8, paragraph (b)(4), line 4, the language "December 26, 2002." is corrected to read "December 26, 2001.".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Associate Chief Counsel
(Income Tax and Accounting).

(Filed by the Office of the Federal Register on March 18, 2002, 8:45 a.m., and published in the issue of the Federal Register for March 19, 2002, 67 F.R. 12494)

Excise Taxes on Excess Benefit Transactions; Correction

Announcement 2002–39

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains corrections to final regulations (T.D. 8978, 2002–7 I.R.B. 500) that were published in the **Federal Register** on Wednesday, January 23, 2002 (67 FR 3076) relating to the excise taxes on excess benefit transactions.

DATES: This correction is effective January 23, 2002.

FOR FURTHER INFORMATION CONTACT: Phyllis D. Haney, (202) 622–4290 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these corrections are under section 4958 of the Internal Revenue Code.

Need for Correction

As published, the final regulations contain errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the final regulations (T.D. 8978), that were the subject of FR Doc. 02–985, is corrected as follows:

1. On page 3078, column 1, in the preamble under the paragraph heading "*Definition of Applicable Tax-Exempt Organization*", line 6 from the top of the column, the language "to the efficient administration of the" is corrected to read "for the efficient administration of the".

2. On page 3082, column 3, in the preamble under the paragraph heading "*Final Regulatory Flexibility Analysis*", first paragraph, line 13, the language "REP. 104–506 at 56–7, March 28, 1996)" is corrected to read "REP. 506, 104th Congress, 2d SESS. (1996), 53, 56–7)".

3. On page 3083, column 1, in the preamble under the paragraph heading "*Final Regulatory Flexibility Analysis*", first full paragraph, line 1, the language "The objective for the rebuttable" is corrected to read "The objective of the rebuttable".

§ 53.4958–4 [Corrected]

4. On page 3091, column 3, § 53.4958–4(a)(3)(vii), *Example 1*, line 12, the language "T (see § 53.4958–3(a)). Under the initial" is corrected to read "T (see § 53.4958–3(c)(3)). Under the initial".

5. On page 3095, column 2, § 53.4958–4(c)(4), *Example 2*, line 10, the language "D fails to report the bonus on his individual" is corrected to read "D fails to report the bonus on D's individual".

§ 301.7611–1 [Corrected]

6. On page 3099, column 2, in A–19, line 1, the language "A–19: See § 53.4958–7(b) of this" is corrected to read "A–19: See § 53.4958–8(b) of this".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Associate Chief Counsel
(Income Tax and Accounting).

(Filed by the Office of the Federal Register on March 18, 2002, 8:45 a.m., and published in the issue of the Federal Register for March 19, 2002, 67 F.R. 12471)

Renewal of Enrolled Agent Status

Announcement 2002–41

Enrolled agent cards will expire on March 31, 2002. However, all cards for the upcoming three year cycle will not be mailed out by that date. Therefore, the Director of Practice has extended all current enrollment cards until April 30, 2002. Anyone not receiving their enrollment card by that date should call (313) 234–1280 or e-mail the Enrolled Practitioner Unit at *epp@irs.gov*. Enrolled agents may continue to use their existing enrollment card until April 30, 2002.

Renewal of Sponsor Agreements for Enrolled Agent Continuing Professional Education

Announcement 2002–42

Sponsor agreements for sponsors of qualifying continuing professional education expire on March 31, 2002. The Director of Practice will not mail out their approval or disapproval of sponsor agreements for the upcoming three year cycle by that date. Therefore, the Director of Practice has extended all existing sponsor agreements through August 31, 2002. Sponsors will be notified by August 31, 2002, of their renewal status. Sponsors seeking renewal will continue to be approved until that date.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Intemal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
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TFE—Transferee.
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T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
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X—Corporation.
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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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Bulletin No. 2002–15
April 15, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

SPECIAL ANNOUNCEMENT

Announcement 2002–40, page 747.
This announcement concerns Advance Pricing Agreements (APAs) and the experience of the APA Program during calendar year 2001.

TAX CONVENTIONS

Rev. Rul. 2002–16, page 740.
This ruling confirms that the Netherlands investment yield tax is a tax for which a credit may be allowed under Article 25(4) of the U.S.–Netherlands income tax convention because, under Article 2(2), it is substantially similar to a prior Dutch tax that was a covered tax under the convention.

Rev. Proc. 2002–23, page 744.
This document describes new procedures under Article XVIII(7) of the U.S. – Canada income tax convention whereby U.S. taxpayers may elect to defer U.S. income taxation on income accruing in certain Canadian pension plans until a distribution is made from such plans. Rev. Proc. 89–45 superseded.

EMPLOYEE PLANS

Notice 2002–23, page 742.
Form 5500; DOL delinquent filer program. This notice provides relief from certain penalties under sections 6652 and 6692 of the Code for late filers of Form 5500 who are eligible for and satisfy the requirements of the Department of Labor's (DOL's) Delinquent Filer Voluntary Compliance (DFVC) program.

Notice 2002–26, page 743.
Weighted average interest rate update. The weighted average interest rate for the first quarter of 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

Announcement 2002–31, page 747.
Proposed class exemption; non-enforcement policy. This announcement describes the Service's position on the imposition of the prohibited transaction excise taxes during the pendency of a class exemption from the prohibited transaction rules (Application No. D–10933) proposed by the U.S. Department of Labor.

ADMINISTRATIVE

Notice 2002–25, page 743.
Charitable contributions, substantiation, relief. Due to the unique circumstances of the September 11th tragedy, taxpayers who made charitable contributions of $250 or more after September 10, 2001, and before January 1, 2002, are provided with partial relief from the "contemporaneous written acknowledgement" requirement of section 170(f)(8) of the Code with respect to those contributions.

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Department of the Treasury
Internal Revenue Service

Rev. Proc. 2002–23, page 744.

This document describes new procedures under Article XVIII(7) of the U.S. – Canada income tax convention whereby U.S. taxpayers may elect to defer U.S. income taxation on income accruing in certain Canadian pension plans until a distribution is made from such plans. Rev. Proc. 89–45 superseded.

Rev. Proc. 2002–26, page 746.

This procedure provides updated information about how the Service applies partial undesignated payments against assessed tax, penalty, and interest. Rev. Ruls. 73–304, 73–305, and 79–284 superseded.

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Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

United States — Kingdom of the Netherlands Income Tax Convention

This ruling confirms that the Netherlands investment yield tax is a tax for which a credit may be allowed under Article 25(4) of the U.S.-Netherlands income tax convention because, under Article 2(2), it is substantially similar to a prior Dutch tax that was a covered tax under the convention.

Rev. Rul. 2002–16

ISSUE

Whether the newly enacted Dutch tax on an individual's imputed income from savings and investment in the Netherlands, Box 3 of the Netherlands Individual Income Tax Act of 2001, is a tax for which a credit may be allowed against U.S. income tax liability under the Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, effective December 31, 1993 (the "Treaty").

FACTS

Prior to January 1, 2001, the Netherlands individual income tax (*de inkomstenbelasting*) was imposed on a single taxable income base, which comprised all the income that a taxpayer received in a year. Various deductions were allowed against this income. Additionally, a dividend and interest allowance could be used against income from savings and investments.

Effective January 1, 2001, the Netherlands introduced a schedular system of individual taxation that applies to both residents and nonresidents. Under the new system, instead of a single taxable income base there are three separate bases. These are referred to as "Boxes," and are organized as follows:

Box 1 includes taxable income from work (including profits and losses from business and professions and sales of business property, wages, pensions, and income from partnerships), dividends received by security dealers, and imputed income from an owner-occupied home. Expenses related to business profits are deductible. Nonresidents are subject to tax on the income in this box from Dutch sources, including imputed income from a home within the Netherlands.

Box 2 includes taxable income derived from a substantial business interest in corporations. Substantial is defined as a 5% or more interest. Two types of income are taxed: dividends and capital gain realized on selling assets that form a substantial holding. Acquisition (margin) interest is deductible. Nonresidents are subject to tax on the income in this box with regard to substantial interests in Dutch companies.

Box 3 includes taxable income from savings and investments. Taxable income is the fixed yield (imputed income) set at 4% of the value of the investment assets reduced by certain liabilities. Taxpayers cannot reduce their tax burden by proving that their actual rate of return on investments was in fact less than 4%. If income imputed from investment assets is subject to tax under Box 3, any actual interest, dividend, and rental income will not be taxed. The investment yield tax applies to assets such as real estate (other than the taxpayer's personal residence), stocks and shares, savings deposits, and non-exempt endowment insurance. If income from an asset is subject to tax under Box 1 or 2, income will not be imputed with respect to that asset for purposes of Box 3. Also, income is not imputed with respect to assets without yield capacity (such as personal use property). Interest paid and other expenses relating to imputed income taxed under Box 3 are not deductible. However, debt that exceeds 2,500 EUR and that is not related to the assets included within Box 1 and Box 2 can be deducted from the tax base on which the imputed income of 4% is computed; in addition, all taxpayers are entitled to a tax-free asset allowance of 17,600 EUR. Nonresidents are subject to tax on the income in this box from assets within the Netherlands minus related debt. Assets within the Netherlands include only immovable property, rights in immovable property, and rights in the profits of a company with a registered office within the Netherlands provided that the rights are not in the form of stock.

Under the new system, each form of income may be included in only one box. If there is a loss in one box, it may not offset positive income in the other two boxes. The loss may, however, be carried over and deducted against income in that box in a later year. In addition, if a taxpayer incurs a loss on the complete termination of his or her substantial interest that is subject to tax in Box 2, as much as 25% of that loss may be applied against the Box 1 tax.

Box 1 taxable income comprises approximately 95% of the total income tax base. Boxes 2 and 3 comprise approximately 1.5% and 3.5% respectively of the total income tax base.

Taxable income within the three boxes is reduced by personal deductions, such as medical expenses, educational expenses, donations, and alimony. Personal deductions are used to offset first income in Box 1, then income in Box 3, and finally income in Box 2. Any excess personal deductions may be carried forward.

After reduction by personal deductions, taxable income is subject to the following income tax rates in the three boxes as follows:

Box 1	Progressive rates of up to 52%
Box 2	25%
Box 3	30%

Various credits are allowed against the taxes of the three boxes combined. Some of these credits, such as the general tax credit, child credit, old-age credit, and the handicapped credit, are nonrefundable. Two additional credits, a wage credit and a credit for the dividend tax, also are allowed, and may, in some cases, lead to a refund.

LAW AND ANALYSIS

Under Article 25(4) of the Treaty, a credit may be allowed against U.S. tax liability for the Box 3 tax if, under Article 2(2), the Box 3 tax is a substantially similar tax imposed in place of a tax that was in force at the time the Treaty was signed. Under the general rule of Article 25(4) of the Treaty, Methods of Elimination of Double Taxation, the United States treats as an income tax, for which a credit may be allowed under Article 25, the appropriate amount of income tax paid or accrued to the Netherlands by or on behalf of a resident or national of the United States. For purposes of Article 25(4), the taxes referred to in paragraphs 1(a) and 2 of Article 2, Taxes Covered, are considered income taxes.

Article 2(1)(a) lists the Netherlands taxes that were in force at the time the Treaty was signed and that were covered under the Treaty. These included the Dutch individual income tax, *de inkomstenbelasting*.

Under Article 2(2), Netherlands taxes that were not in force at the time the Treaty was signed are nonetheless covered taxes, and thus taxes for which a credit may be allowed under Article 25(4), if they are identical or substantially similar taxes imposed after the date of signature of the Treaty in addition to, or in place of, the existing taxes.

In general, the purpose of a Taxes Covered Article is to ensure that tax treaties do not become obsolete due to changes in the tax systems of the parties to a treaty. Thus, if identical or substantially similar taxes are imposed in addition to, or in place of, the taxes that were in force and covered at the time a treaty was signed, it is appropriate to give effect to the intent of the Contracting States, and allow the treaty to continue to apply to the basic income tax structures of Contracting States. There is no definitive test for whether a tax is substantially similar to a covered tax; rather, the outcome rests on the facts and circumstances of each particular case. If it is concluded that a newly enacted tax is substantially similar to a covered tax, it also becomes a covered tax, but remains so only until such time as it is amended. When that occurs, a separate analysis must be made in order to determine whether the amended tax is substantially similar to the taxes in force at the time the treaty was signed.

HOLDINGS

Considered in its entirety, the Netherlands Individual Income Tax Act of 2001 imposes taxes that are substantially similar to the income tax referred to in Article 2(1)(a) of the Treaty. Because the taxes imposed pursuant to the Netherlands Individual Income Tax Act of 2001 are substantially similar to the income tax referred to in Article 2(1)(a) of the Treaty, those taxes are covered under Article 2(2), and therefore treated as income taxes for which a credit may be allowed under Article 25(4). Accordingly, the tax imposed under Box 3, which forms a part of the Netherlands Individual Income Tax Act of 2001, is treated as an income tax for which a credit may be allowed under Article 25(4).

Taxpayers generally may rely upon Revenue Rulings to determine the tax treatment of their own transactions, and need not request a ruling that would apply the principles of a published Revenue Ruling to their own particular cases. However, because each Revenue Ruling represents the conclusion of the Service as to the application of the law to the specific facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusions in other cases unless those cases present facts and circumstances that are substantially the same as those in the Revenue Ruling. Treas. Reg. § 601.601 (d)(2)(v)(*e*). Accordingly, because the provisions of the Netherlands Individual Income Tax Act of 2001 described in this Revenue Ruling are facts on which this Ruling bases its holding, a taxpayer must verify that the description is still accurate before relying on the Ruling. A taxpayer may not rely on the Ruling if the Netherlands Individual Income Tax Act of 2001 has been altered or changed in any material respect by subsequent Dutch law.

EFFECTIVE DATE

This Revenue Ruling is effective with respect to taxable years beginning on or after January 1, 2001. This Revenue Ruling will cease to be effective if the Netherlands Individual Income Tax Act of 2001 is modified in any material respect for tax years that are affected by such change. Taxpayers are responsible for determining whether any such modifications have occurred.

DRAFTING INFORMATION

The principal author of this Revenue Ruling is Nina Chowdhry of the Office of the Associate Chief Counsel (International) (CC:INTL:Br1). For further information regarding this Revenue Ruling, contact Ms. Chowdhry at (202) 622–3880 (not a toll-free call).

Part III. Administrative, Procedural, and Miscellaneous

Relief From Internal Revenue Code Late Filer Penalties

Notice 2002–23

PURPOSE

This notice provides administrative relief from the penalties under §§ 6652 (c)(1), (d), (e), and 6692 of the Internal Revenue Code (the "Code") for failure to timely comply with the annual reporting requirements under §§ 6033(a), 6057, 6058, 6047, and 6059 of the Code. This administrative relief applies to late filers who both are eligible for and satisfy the requirements of the Delinquent Filer Voluntary Compliance Program ("DFVC Program"), which is administered by the Department of Labor's ("DOL") Pension and Welfare Benefits Administration ("PWBA"). The DFVC Program was published on April 27, 1995, in the Federal Register (60 FR 20874). A modification of the DFVC Program was published on March 28, 2002 (67 FR 15051).

BACKGROUND

Plan administrators who fail to file Form 5500 annual returns/reports on a timely basis can be subject to civil penalties under both Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") and the Code. The Secretary of Labor has the authority under section 502(c)(2) of ERISA and 29 CFR 2575.502c–2 to assess civil penalties of up to $1,100 per day against plan administrators who fail or refuse to file complete and timely annual reports.

Pursuant to 29 CFR 2560.502c–2 and 29 CFR 2570.60 *et seq.*, PWBA maintains an administrative program for the assessment of civil penalties for noncompliance with the annual reporting requirements. Under this program, plan administrators filing late annual reports may be assessed a penalty of $50 per day for each day of noncompliance. Plan administrators who fail to file an annual report may be assessed a penalty of $300 per day, up to $30,000 per year, until a complete annual report is filed.

In addition to the civil penalties that may be assessed by DOL under section 502(c)(2) of ERISA, the Internal Revenue Service (the "Service") may assess penalties under §§ 6652(c)(1), (d), (e) and 6692 of the Code for the failure to satisfy the annual reporting requirements. Section 6652(c)(1) generally provides that in the case of any failure to file a return under § 6033(a), the exempt organization shall pay an amount equal to $20 for each day during which the failure continues, not to exceed the maximum amount specified under the Code. Section 6652(d)(1) generally provides that in the case of any failure to file an annual registration statement under § 6057(a), the late filer shall pay, upon notice and demand, a penalty of $1 for each participant with respect to whom there is a failure to file for each day the failure continues, up to $5,000 for any plan year. Section 6652(d)(2) generally provides that in the case of any failure to file a notification of change of status, the late filer shall pay, upon notice and demand, a penalty of $1 for each day the failure continues, up to $1,000. Section 6652(e) generally provides, in part, that in the case of any failure to file a return or statement required under §§ 6058 or 6047(e), the late filer shall pay, upon notice and demand, a penalty of $25 for each day the failure continues, up to $15,000 per return or statement. Section 6692 generally provides that in the case of any failure to file a report required by § 6059, the late filer shall pay a penalty of $1,000 for each failure.

DOL ADMINISTRATIVE RELIEF FROM PENALTY

In order to encourage voluntary compliance with the annual reporting requirements by late filers, DOL implemented the DFVC Program. Plan administrators who are subject to the assessment of civil penalties for failing to file a timely annual report and who are eligible for the DFVC program may pay reduced civil penalties by voluntarily complying with the terms of the DFVC Program.

ADMINISTRATIVE RELIEF FROM CERTAIN INTERNAL REVENUE CODE PENALTIES FOR DFVC PROGRAM PARTICIPANTS

The Service will not impose the penalties under §§ 6652(c)(1), (d), (e), and 6692 (as these sections relate to the filing of a Form 5500) on a person who is eligible for and satisfies the requirements of the DFVC Program with respect to the filing of a Form 5500. Once the late filer satisfies the requirements of the DFVC Program, including paying the reduced civil penalty under section 502(c)(2) of ERISA, the relief under this notice will apply. The late filer need not file a separate application for relief with the Service. The Service will coordinate with DOL in determining which late filers are eligible for the relief under this notice.

INAPPLICABILITY OF THE ABOVE RELIEF FOR CERTAIN FILERS

The relief under this notice is available only to the extent that a Form 5500 is required under Title I of ERISA. Therefore, for example, Form 5500–EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3–3(b) and (c)) are not eligible for the relief in this notice. Because such plans are not subject to Title I of ERISA, they are ineligible to participate in the DFVC Program.

DRAFTING INFORMATION

The principal drafters of this notice are Steven J. Linder of the Employee Plans, Tax Exempt and Government Entities Division and Pamela Kinard of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, please contact Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Linder may be reached at (202) 283–9888; Ms. Kinard may be reached at (202) 622–6060. The telephone numbers in the preceding sentence are not toll-free.

Partial Relief From the Substantiation Requirements of Section 170(f)(8) of the Internal Revenue Code for Charitable Contributions Made After September 10, 2001, and Before January 1, 2002

Notice 2002–25

PURPOSE

Due to the unique circumstances of the September 11th tragedy, the Internal Revenue Service is providing taxpayers who made certain charitable contributions of $250 or more with partial relief from the "contemporaneous written acknowledgment" requirement of § 170(f)(8) of the Internal Revenue Code with respect to those contributions. Taxpayers will be treated as satisfying the contemporaneous written acknowledgment requirement with respect to contributions made after September 10, 2001, and before January 1, 2002, if, on or before October 15, 2002, they either obtain the required acknowledgment from the donee organization, or have evidence of a good faith effort to obtain it.

BACKGROUND

Section 170 generally allows a deduction for charitable contributions made during the taxable year. With respect to contributions of $250 or more, the deduction is allowable only if the donor obtains a written acknowledgment from the donee organization on or before the date the donor files the return reporting the contribution or on or before the due date (including extensions) of the return, whichever comes first. Section 170(f)(8).

A contemporaneous written acknowledgment is a timely written statement from the donee organization that contains the following information: (1) the amount of cash and a description (but not value) of any property other than cash contributed; (2) whether the donee organization provided any goods or services in consideration for the property contributed; and (3) a description and good faith estimate of the value of any goods or services provided by the donee organization in consideration for the property contributed. The donee organization may provide a paper copy of the acknowledgment to the donor, or the donee organization may provide the acknowledgment electronically, such as in an e-mail addressed to the donor. See Publication 1771, "Charitable Contributions—Substantiation and Disclosure Requirements."

The Service has become aware that, due to the overwhelming number of charitable contributions made in the wake of September 11th, many donee organizations are unable to supply donors with the required acknowledgments in a timely manner.

RELIEF

Under these unique circumstances, the following partial relief is provided: A donor that contributed $250 or more of cash or other property after September 10, 2001, and before January 1, 2002, and has not obtained a written acknowledgment by the date specified in § 170(f)(8), will be treated as having satisfied the requirements of that section if, on or before October 15, 2002, the donor either obtains the required acknowledgment, or has evidence of a good faith effort to obtain it. An example of a good faith effort is sending the donee organization a letter or e-mail requesting a written acknowledgment that meets the requirements of § 170(f)(8). A copy of that letter or e-mail is evidence of a good faith effort.

Donors are reminded that they must comply with all of the other requirements of § 170 in order to be allowed charitable contribution deductions. For example, donors must comply with the requirement that they maintain records to substantiate the fact and amount of a transfer to a qualified charity within the taxable year.

DRAFTING INFORMATION

The principal authors of this notice are Patricia Zweibel and Susan Kassell of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Ms. Zweibel or Ms. Kassell at (202) 622–5020 (not a toll-free call).

Weighted Average Interest Rate Update

Notice 2002–26

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73 (1988–2 C.B. 383) provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under §§ 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for February 2002 is 5.40 percent. The Service has determined this rate as the average of the 30-year Treasury Constant Maturity interest rate determined each day through February 18, 2002 (as reported in § H.15 on the Federal Reserve website (*www.federalreserve.gov/releases*)), and the yield on the 30-year Treasury bond maturing in February 2031, determined each day for the balance of the month.

Effective for March 2002, the Service will determine and publish the rate of

interest on 30-year Treasury Securities solely on the basis of the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031. The Service will determine and publish the average yield on such basis for an interim period, pending the enactment of legislative changes to §§ 412 and 417 that address the discontinuance of the 30-year Treasury bond.

Section 405 of the Job Creation and Worker Assistance Act of 2002 ("JCWAA") amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 120% Permissible Range	90% to 110% Permissible Range
January	2002	5.71	5.14 to 6.85	5.14 to 6.28
February	2002	5.70	5.13 to 6.84	5.13 to 6.27
March	2002	5.69	5.12 to 6.83	5.12 to 6.26

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1–202–283–9888 (not a toll-free number).

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26 CFR 601.602: Tax forms and instructions.
(Also Part I, section 894; Part II, United States-Canada Income Tax Convention.)

Rev. Proc. 2002–23

SECTION 1. PURPOSE

This revenue procedure provides guidance for applying Article XVIII(7) of the United States-Canada Income Tax Convention, signed on September 26, 1980, as amended by Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (the "Convention"). It supersedes Revenue Procedure 89–45 (1989–2 C.B. 596), which provided guidance for applying former Article XXIX(5) of the Convention. Article XVIII(7), which was added to the Convention by the Protocol that was signed on March 17, 1995, expanded and replaced Article XXIX(5).

SECTION 2. BACKGROUND

.01 *Domestic Rules*. Under the domestic law of the United States, an individual who is a citizen or resident of the United States and a beneficiary of a Canadian retirement plan will be subject to current United States income taxation on income accrued in the plan even though the income is not currently distributed to the beneficiary, unless the plan is an employees' trust within the meaning of section 402(b) of the Internal Revenue Code and the individual is not a highly compensated employee subject to the rule of section 402(b)(4)(A). However, if the plan satisfies certain requirements under the domestic law of Canada, the income accrued in the plan will not be subject to Canadian income taxation until it is actually distributed from the plan (or from another plan to which it is transferred in a tax-free rollover). Thus, there may be a mismatch between the timing of the United States tax and the Canadian tax, with the result that the individual may be subject to double taxation for which no relief is available under Article XXIV of the Convention.

.02 *Former Article XXIX(5)*. Former Article XXIX(5) of the Convention addressed the timing mismatch in respect of a U.S. citizen who was a resident of Canada and a beneficiary of a Canadian registered retirement savings plan ("RRSP") by providing that such a U.S. citizen could elect, under rules established by the competent authority of the United States, to defer United States taxation with respect to any income accrued in the RRSP but not distributed by the RRSP, until such time as a distribution was made from such RRSP or any plan substituted therefor. The rules for making an election under former Article XXIX(5) were set forth in Revenue Procedure 89–45. Additional guidance was set forth in Revenue Ruling 89–95 (1989–2 C.B. 131), which provided that if the proceeds of a RRSP were rolled over to a Canadian registered retirement income fund ("RRIF"), the RRIF would be treated as a plan substituted for the RRSP, with the result that both the proceeds that were rolled over from the RRSP and the income subsequently accrued in the RRIF could qualify for deferral under former Article XXIX(5).

.03 *Article XVIII(7)*. Article XVIII(7) of the Convention now provides, effective for taxable years beginning on or after January 1, 1996, that a natural person who is a citizen or resident of either the United States or Canada and a beneficiary of a trust, company, organization, or other arrangement that is a resident of the other country that is generally exempt from income taxation in the other country (a "plan"), and is operated exclusively to provide pension, retirement, or employee benefits, may elect to defer taxation in the person's country of citizenship or residence, under rules established by the competent authority of that country, with respect to any income accrued in the plan but not distributed by the plan, until such time as and to the extent that a distribution is made from the plan or any plan substituted therefor.

SECTION 3. SCOPE

This revenue procedure applies to an individual who is a citizen or resident of the United States and a beneficiary of one of the following Canadian plans (an "eligible plan"): a RRSP, a RRIF, a registered pension plan, or a deferred profit sharing plan. This revenue procedure applies regardless of whether the individual was a resident of Canada at the time contributions were made to the eligible plan. For purposes of this revenue procedure, a "beneficiary" of an eligible plan is an individual who would, in the absence of an election under Article XVIII(7) of the Convention, be subject to current United States income taxation on income accrued in the plan. The revenue procedure applies only to income accrued in an eligible plan and not to any contributions to the plan.

SECTION 4. ELECTION PROCEDURES

.01 *In General*. If income accruing in an eligible plan would otherwise be subject to current United States income taxation, a beneficiary of the eligible plan may elect for the beneficiary's taxable year (the "current year") and all subsequent years to defer United States income tax on the beneficiary's share of income accrued in the plan until that income is distributed to the beneficiary. Beneficiaries shall make the election by attaching to their timely filed (including extensions) United States federal income tax return for the current year, a statement that includes the following information:

(i) A statement that the taxpayer is claiming the benefit of Article XVIII(7) of the Convention under this revenue procedure;

(ii) The name of the trustee of the plan and the plan account number, if any; and

(iii) The balance in the plan at the beginning of the current year.

.02 *Reporting*. Beneficiaries shall attach a copy of the statement required in paragraph 4.01 to their timely filed (including extensions) United States federal income tax return for each year subsequent to the current year, until the tax year in which a final distribution is made from the plan (or from any transferee plan within the meaning of paragraph 4.03).

.03 *Rollovers*. If an eligible plan for which an election has been made pursuant to paragraph 4.01 ("transferor plan") is rolled over to another eligible plan ("transferee plan") in a transfer that does not result in the current imposition of Canadian income tax (*e.g.*, a transfer such as that described in Revenue Ruling 89–95), the previous election is deemed to carry over to the transferee plan.

.04 *Transferee Plan Reporting*. In the case of a transferee plan, in addition to a copy of the statement required for the transferor plan under paragraph 4.02, in the tax year of the transfer ("transfer year"), beneficiaries shall attach an additional statement that includes the following information:

(i) A statement that the taxpayer is claiming the benefit of Article XVIII(7) of the Convention under this revenue procedure;

(ii) The name of the trustee of the transferee plan and the plan account number, if any;

(iii) The name of the trustee of the transferor plan and the plan account number, if any;

(iv) The total amount of income accrued in the transferor plan on which United States income tax was deferred under either Article XVIII(7) or former Article XXIX(5); and

(v) The initial balance in the transferee plan.

Beneficiaries of a transferee plan shall attach a copy of the statement required in paragraph 4.02 (transferor plan) and a copy of the statement required in this paragraph 4.04 (transferee plan) to their timely filed (including extensions) United States federal income tax return for each year subsequent to the transfer year, until the tax year in which a final distribution is made from the transferee plan.

.05 *Multiple Plans*. An individual who is a beneficiary of more than one eligible plan must make a separate election and file a separate statement for each eligible plan.

.06 *Extension Of Time For Making Elections*. An extension of time for making an election under paragraph 4.01 may be available under the procedures applicable under sections 301.9100–1 and 301.9100–3 of the Procedure and Administration Regulations.

.07 *Prospective Change of Election*. An election once made cannot be revoked except with the consent of the Commissioner.

SECTION 5. DISTRIBUTIONS FROM AN ELIGIBLE PLAN

Distributions received by a beneficiary from an eligible plan shall be included in gross income by the beneficiary in the manner provided under section 72 of the Internal Revenue Code, subject to any other applicable provision of the Convention.

SECTION 6. EFFECT ON OTHER DOCUMENTS

This revenue procedure supersedes Revenue Procedure 89–45 (1989–2 C.B. 596).

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2001. For taxable years ending before such date and beginning on or after January 1, 1996, taxpayers may elect to apply either this revenue procedure or Revenue Procedure 89–45.

SECTION 8. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1773.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this revenue procedure is in section 4. This information is required to enable taxpayers to claim a benefit under the Convention. This information will be used to compute and collect the right amount of tax. The likely respondents are individuals.

The estimated total annual reporting burden is 10,000 hours. The estimated annual burden per respondent varies from

0.1 hour to 1 hour, depending on individual circumstances, with an estimated average of 0.5. The estimated number of respondents is 20,000.

The estimated annual frequency of responses is once per respondent.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal authors of this revenue procedure are M. Grace Fleeman and Amanda A. Ehrlich of the Office of the Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Amanda A. Ehrlich at (202) 622–3880 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, §§ 163, 6601, 7122; 1.163–9T, 301.6601–1, 301.7122–1)

Rev. Proc. 2002–26

SECTION 1. PURPOSE

The purpose of this revenue procedure is to update and restate the Internal Revenue Service's position regarding the application, by the Service, of a partial payment of tax, penalty, and interest for one or more taxable periods. This revenue procedure supersedes Rev. Rul. 73–304 (1973–2 C.B. 42); Rev. Rul. 73–305 (1973–2 C.B. 43); and Rev. Rul. 79–284 (1979–2 C.B. 83).

SECTION 2. SCOPE

This revenue procedure applies to all taxes under the Internal Revenue Code, except alcohol, tobacco, and firearms taxes and the harbor maintenance tax. For purposes of this revenue procedure, the term "penalty" includes any additional amount, addition to tax, or assessable penalty.

SECTION 3. PROCEDURE

.01 If additional taxes, penalty, and interest for one or more taxable periods have been assessed against a taxpayer (or have been mutually agreed to as to the amount and liability but are unassessed) at the time the taxpayer voluntarily tenders a partial payment that is accepted by the Service and the taxpayer provides specific written directions as to the application of the payment, the Service will apply the payment in accordance with those directions.

.02 If additional taxes, penalty, and interest for one or more taxable periods have been assessed against a taxpayer (or have been mutually agreed to as to the amount and liability but are unassessed) at the time the taxpayer voluntarily tenders a partial payment that is accepted by the Service and the taxpayer does not provide specific written directions as to the application of payment, the Service will apply the payment to periods in the order of priority that the Service determines will serve its best interest. The payment will be applied to satisfy the liability for successive periods in descending order of priority until the payment is absorbed. If the amount applied to a period is less than the liability for the period, the amount will be applied to tax, penalty, and interest, in that order, until the amount is absorbed.

.03 Payments made pursuant to the terms of offers in compromise (or offers in compromise and collateral agreements) that have been accepted by the Government in compromise of outstanding tax liabilities, in accordance with § 7122 of the Internal Revenue Code, will be applied as follows:

(1) If an offer in compromise and collateral agreement have been accepted by the Government in compromise of an outstanding liability and the offer in compromise and collateral agreement provide for the allocation of payments made pursuant thereto, payments made pursuant to the agreements will be applied by the Service in accordance with the terms of the agreements.

(2) In all other cases, the Service will apply payments, whether paid in installments or in a lump sum and whether paid pursuant to the offer or a collateral agreement, to periods in the order of priority that the Service determines will serve its best interest. The payment will be applied to satisfy the liability for successive periods in descending order of priority until the payment is absorbed. If the amount applied to a period is less than the liability for the period, the amount will be applied to tax, penalty, and interest, in that order, until the amount is absorbed.

.04 If any part of a payment is applied to interest under the rules set forth in this revenue procedure, the amount applied to interest is treated for purposes of § 163 of the Code as interest paid in the year in which the payment is made. Under § 163, interest paid or accrued in a taxable year may be deducted in calculating taxable income for the year except to the extent such interest is personal interest as defined in § 163(h) and § 1.163–9T(b)(2) of the Income Tax Regulations or is otherwise disallowed under applicable provisions of the Internal Revenue Code and Income Tax Regulations.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 73–304, Rev. Rul. 73–305, and Rev. Rul. 79–284 are hereby superseded.

SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is Inga Plucinski of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice. For further information regarding this revenue procedure, contact Emly Berndt at (202) 622–4940 (not a toll-free call).

Part IV. Items of General Interest

Prohibited Transactions — Proposed Class Exemption and the Voluntary Fiduciary Correction Program

Announcement 2002–31

On March 15, 2000, the U.S. Department of Labor (the "DOL") published at 65 **Fed. Reg.** 14164, its interim Voluntary Fiduciary Correction ("VFC") program. On March 28, 2002, the DOL adopted its permanent VFC program. In conjunction with that program, the DOL, which, generally, has the authority to determine whether a transaction is prohibited under § 4975 of the Internal Revenue Code, published a notice of a proposed class exemption (Application No. D–10933) from the prohibited transaction rules pertaining to four of the enumerated transactions that come under the VFC program.

The proposed class exemption when finalized will provide relief from the sanctions of § 4975 (a) and (b) of the Internal Revenue Code, *i.e.*, the application of the excise taxes described therein applied as a result of § 4975(c)(1)(A) through (E),[1] with respect to the four enumerated transactions. Among the conditions for an applicant to be eligible for the proposed class exemption are the following: (1) meeting the requirements of the VFC program pertaining to the particular transaction, (2) receiving a no action letter from the DOL regarding the transaction, and (3) providing notice to all interested persons.

The Service recognizes that a disqualified person who meets the conditions described in the proposed class exemption could nevertheless be subject to the sanctions of § 4975 during the pendency of the proposed class exemption despite the fact that the proposed class exemption when finalized will cause those sanctions not to apply with respect to the transactions enumerated in the class exemption (assuming all of the conditions of the class exemption are met). In order to encourage fiduciaries that meet the terms of the proposed class exemption to participate in the DOL's VFC program and to remove a significant disincentive from participating in that program, the Service will not seek to impose the § 4975 (a) and (b) excise taxes with respect to any prohibited transaction that is covered by the proposed class exemption notwithstanding any subsequent changes to the proposed class exemption when it is finalized, provided that all of the requirements specified in the proposed class exemption are met.

Drafting Information

The principal author of this announcement is Michael Rubin of the Tax Exempt and Government Entities Division, Employee Plans. For further information regarding this announcement, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Rubin can be contacted at 202–283–9888 (not a toll-free number).

[1] The prohibited transactions described in § 4975(c)(1)(F), *i.e.*, the receipt of any consideration for his of her own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan, does not come within the framework of the DOL's proposed class exemption or this announcement.

Announcement and Report Concerning Advance Pricing Agreements

Announcement 2002–40

March 29, 2002

This Announcement is issued pursuant to § 521(b) of Pub. L. 106–170, the Ticket to Work and Work Incentives Improvement Act of 1999, requiring that the Secretary of the Treasury annually report to the public concerning Advance Pricing Agreements (APAs) and the APA Program. The first report, in Announcement 2000–35 (2000–1 C.B. 922), covered calendar years 1991 through 1999. The second report, in Announcement 2001–32 (2001–17 I.R.B. 1113), described the experience of the APA Program during calendar year 2000. This third report describes the experience of the APA Program during calendar year 2001 consistent with the mandate of § 521(b). This document does not provide general guidance regarding the application of the arm's length standard; rather, it reports on the structure and activities of the APA program.

Sean F. Foley
Director, Advance Pricing Agreement Program

Background

IRC § 482 provides that the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled businesses if necessary to reflect clearly the income of such businesses. Under the regulations, the standard to be applied in determining the true taxable income of a controlled business is that of a business dealing at arm's length with an unrelated business. The arm's length standard also has been adopted by the international community

and is incorporated into the transfer pricing guidelines issued by the Organization for Economic Cooperation and Development (OECD). OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators (1995). Transfer pricing issues by their nature are highly factual and have traditionally been one of largest issues identified by the IRS in its audits of multinational corporations. The Advance Pricing Agreement (APA) Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method. In year 2001, the IRS and taxpayers executed 55 APAs and amended 7 APAs.

Since 1991, with the issuance of Rev. Proc. 91–22 (1991–1 C.B. 526), the IRS has offered taxpayers through the APA Program the opportunity to reach an agreement in advance of filing a tax return on the appropriate transfer pricing methodology (TPM) to be applied to related party transactions. In 1996, the IRS issued internal procedures for processing APA requests. Chief Counsel Directives Manual (CCDM), ¶¶(42)(10)10–(42)(10)(16)0 (November 15, 1996). Also in 1996, the IRS updated Rev. Proc. 91–22 with the release of Rev. Proc. 96–53 (1996–2 C.B. 375). The APA Program continues to operate under the provisions of Rev. Proc. 96–53, which provides taxpayers with instructions of how to apply for an APA, and what to expect in the processing of the case.[1] In addition, in 1998, the IRS published Notice 98–65 (1998–2 C.B. 803), which set forth streamlined APA procedures for Small Business Taxpayers (SBTs). That Notice also expanded the availability of the lowest APA user fee in an effort to attract taxpayers who may not have the resources to do the sophisticated economic studies normally required in APA submissions.

Advance Pricing Agreements

An APA generally combines an agreement between a taxpayer and the IRS on an appropriate transfer pricing methodology (TPM) for the transactions at issue (Covered Transactions) with an agreement between the U.S. and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties) that the TPM is correct. With such a "bilateral" APA, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by the IRS and the foreign tax authority. It is the policy of the United States, as reflected in § 7 of Rev. Proc. 96–53 to encourage taxpayers that enter the APA program to seek bilateral or multilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (a "unilateral" APA).

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved transfer pricing methodology for U.S. tax purposes. A unilateral APA binds the taxpayer and the IRS, but obviously does not prevent foreign tax administrations from taking different positions on the appropriate transfer pricing methodology for a transaction. As stated in Rev. Proc. 96–53, should a transaction covered by a unilateral APA be subject to double taxation as the result of an adjustment by a foreign tax administration, the taxpayer may seek relief by requesting that the U.S. competent authority consider initiating a mutual agreement proceeding, provided there is an applicable income tax treaty in force with the other country.

When a unilateral APA involves taxpayers operating in a country that is a treaty partner, information relevant to the APA (including a copy of the APA and APA annual reports) may be provided to the treaty partner under normal rules and principles governing the exchange of information under income tax treaties.

The APA Program

APAs are negotiated with the taxpayer by an IRS team headed by an APA team leader. As of December 31, 2001, the APA program had 22 team leaders, of whom 21 were attorneys and 1 was a former international examiner. The team leader is responsible for organizing the IRS APA team, arranging meetings with the taxpayer, securing whatever information is necessary from the taxpayer to analyze the taxpayer's related party transactions, analyzing the available facts under the arm's length standard of § 482 and the regulations, and negotiating with the taxpayer.

The APA team generally includes an economist, an international examiner and, in a bilateral case, a competent authority analyst who leads the discussions with the treaty partner. The economist may be from the APA Program or from the IRS field organization. The APA team may include LMSB field counsel, other LMSB exam personnel, and an appeals officer.

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[1] In an effort to encourage taxpayers to utilize the APA process, in 1997 the IRS instituted an Early Referral Program by which, in appropriate cases, field examination teams may suggest to taxpayers that APAs be pursued before substantial time is spent examining transfer pricing issues. Since the reorganization of the IRS in 2000 into separate business units, the Large & Midsize Business (LMSB) Division has encouraged taxpayers to resolve their issues through a variety of pre-filing programs, including APAs. As a result, the IRS is no longer separately tracking APA cases under the 1997 Early Referral Program.

The APA Process

The APA process is voluntary. Taxpayers submit an application for an APA, together with a user fee as set forth in Rev. Proc. 96–53. The APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting and execution.

(1) *The APA Application*

In many APA cases, the taxpayer's application is preceded by a pre-file conference with the APA staff in which the taxpayer can solicit the informal views of the APA Program. Pre-file conferences can occur on an anonymous basis, although a taxpayer must disclose its identity when it applies for an APA. Taxpayers must file the appropriate user fee on or before the due date of the tax return for the first taxable year that the taxpayer proposes to be covered by the APA. Many taxpayers file a user fee first and then follow up with a full application later. The procedures for pre-file conferences, user fees, and delayed applications can be found in Rev. Proc. 96–53.

The APA application can be a relatively modest document for a small business taxpayer. Notice 98–65 describes the special APA procedures for small businesses. For most taxpayers, however, the APA application is a substantial document filling several binders. The APA Program makes every effort to reach agreement on the basis of the information provided in the taxpayer's application.

The application is assigned to an APA team leader who will be responsible for the case. The APA team leader's first responsibility is to organize the APA team. This involves contacting the appropriate LMSB International Territory Manager to secure the assignment of an international examiner to the APA case and the LMSB Counsel's office to secure a field counsel lawyer. In a bilateral case, the U.S. Competent Authority will assign a competent authority analyst to the team. In a large APA case, the international examiner may invite his or her manager and other LMSB personnel familiar with the taxpayer to join the team. When the APA may affect taxable years in Appeals, the appropriate appellate conferee will be invited to join the team. The APA team leader will then distribute copies of the APA application to all team members and will set up an opening conference with the taxpayer. The APA office strives to hold this opening conference within 45 days of the receipt of the complete application. At the opening conference, the APA team leader will propose a schedule designed to complete the recommended U.S. negotiating position for a bilateral APA within 9 months from the date the full application was filed and to complete a unilateral APA within 12 months from the application date. In 2001, the median for completing negotiating positions was 22.9 months (average 25.6), and the median for completing unilateral APAs was 16.0 months (average 16.8).

(2) *Due Diligence*

The APA team must satisfy itself that the relevant facts submitted by the taxpayer are complete and accurate. This due diligence aspect of the APA is vital to the process. It is because of this due diligence that the IRS can reach advance agreements with taxpayers in the highly factual setting of transfer pricing. Due diligence can proceed in a number of ways, but in a large case the taxpayer and the APA team typically will agree to a meeting, or more often to a series of meetings on dates, established in the opening conference. In advance of the meeting, the APA team leader will submit a list of questions to the taxpayer for discussion at the meeting. The meeting may result in a second set of questions. These questions from the IRS are developed jointly by the APA team leader and the IRS field. It is important to note that this due diligence is not an audit and is focused only on the transfer pricing issues associated with the transactions in the taxpayer's application, or such other transactions that the taxpayer and the IRS may agree to add.

(3) *Analysis*

A significant part of the analytical work associated with an APA is done typically by the APA or IRS field economist assigned to the case. The analysis may result in the need for additional information. Once the APA team has completed its due diligence and analysis, the APA team leader will begin negotiations with the taxpayer over the various aspects of the APA including the selection of comparable transactions, asset intensity and other adjustments, the transfer pricing methodology, which transactions to cover, the appropriate critical assumptions, the APA term, and other key issues. The APA team leader will discuss particularly difficult issues with his or her managers, but in the main the APA team leader is empowered to negotiate the APA.

(4) *Discussion and Agreement*

This phase differs for bilateral and unilateral cases. In a bilateral case, the discussions proceed in two parts and involve two IRS offices — the APA Program and the U.S. Competent Authority. In the first part, the APA team will attempt to reach a consensus with the taxpayer regarding the recommended position that the U.S. Competent Authority should take in negotiations with its treaty partner. This recommended U.S. negotiating position is a paper drafted by the APA team leader and signed by the APA Director that provides the APA Program's view of the best transfer pricing methodology for the covered transaction, taking into account the IRC, the Treasury regulations, the relevant tax treaty, and the U.S. Competent Authority's experience with the treaty partner.

The experience of the APA office and the U.S. Competent Authority is that APA negotiations are likely to proceed more rapidly with a foreign competent authority if the taxpayer fully supports the U.S. negotiating position. Consequently, the APA Office works together with the taxpayer in developing the recommended U.S. position. On occasion, the APA team will agree to disagree with a taxpayer. In these cases, the APA office will send a recommended U.S. negotiating position to the U.S. Competent Authority that includes elements with which the taxpayer does not agree. This disagreement is noted in the paper. The APA team leader also solicits the views of the field members of the APA team, and, in the vast majority of APA cases, the international examiner, LMSB field counsel, and other IRS field team members concur in the position prepared by the APA team leader.

Once the APA Program completes the recommended U.S. negotiating position, the APA process shifts from the APA Program to the U.S. Competent Authority. The U.S. Competent Authority analyst assigned to the APA will take the recommended U.S. negotiating position and prepare the final U.S. negotiating position, which is then transmitted to the foreign competent authority. The negotiations with the foreign competent authority are conducted by the U.S. Competent Authority analyst, most often in face-to-face negotiating sessions conducted periodically throughout the year. At the request of the U.S. Competent Authority analyst, the APA team leader may continue to assist the negotiations.

In unilateral APA cases, the discussions proceed solely between the APA Program and the taxpayer. In a unilateral case, the taxpayer and the APA Program must reach agreement to conclude an APA. Like the bilateral cases, the APA team leader almost always will achieve a consensus with the IRS field personnel assigned to the APA team regarding the final APA. The APA Program has a procedure in which the IRS field personnel are solicited formally for their concurrence in the final APA. This concurrence, or any items in disagreement, is noted in a cover memorandum prepared by the APA team leader that accompanies the final APA sent forward for review and execution.

(5) *Drafting, Review, and Execution*

Once the IRS and the taxpayer reach agreement, the drafting of the final APA generally takes little time because the APA Program has developed standard language that is incorporated into every APA. The current version of this language is found in Attachment A. APAs are reviewed by the Branch Chief and the APA Director. In addition, the substance of each APA is briefed to the Associate Chief Counsel (International) (ACC(I)). On March 1, 2001, the ACC(I) delegated to the APA Director the authority to execute APAs on behalf of the IRS. *See* Chief Counsel Notice CC–2001–016. The APA is executed for the taxpayer by an appropriate corporate officer.

The Current APA Office Structure, Composition, and Operation

In 2001, the APA Office was restructured into four branches. Branches 1 and 3 are staffed with APA team leaders. Branch 2 is a new economist branch and also includes the team leader with the principle responsibility for annual report review. Branch 4 is the new APA West Coast office, located in San Francisco and staffed with a mix of APA team leaders and an economist. Also new in 2000 is a Special Counsel to the Director. As of December 31, 2001, the APA staff was as follows:

<table>
<tr><td colspan="4" align="center">Director's Office
1 Director
1 Special Counsel to the Director
1 Secretary to the Director</td></tr>
<tr><td>Branch 1
1 Branch Chief
1 Secretary
9 Team Leaders</td><td>Branch 2
1 Branch Chief
1 Team Leader
6 Economists</td><td>Branch 3
1 Branch Chief
1 Secretary
9 Team Leaders</td><td>Branch 4
1 Branch Chief
3 Team Leaders
1 Economist</td></tr>
</table>

The APA staffing grew dramatically in 2001, rising from 25 persons at the end of 2000 to 38 as of December 31, 2001. The APA Office also continued to experience relatively high turnover in the past year, although lower than the turnover experienced in 2000. Of the 25 people on the APA staff at the end of 2000, 6 were no longer on the staff at the end of 2001. The hiring and turnover combined to create a significant training challenge in 2001. As of December 31, 2001, 10 of the 22 team leaders and 5 of the 7 economists had been with the program less than a year. In addition, 3 of the 4 branch chiefs were new.

The number of team leaders grew from 16 to 22, while the number of economists increased from 3 to 7. Thus the relative number of economists increased substantially, from a ratio of 5 team leaders per economist, to almost 3 team leaders per economist. This increase in the relative number of APA economists is expected to have a salutary affect on APA case processing time. Historically, APA team leaders have reported that lack of economist support is one of the major impediments to timely case processing. Average caseloads fell from 13 APAs per team leader as of December 31, 2000, to 10 per team leader as of December 31, 2001. This should also help in case timeliness as relatively high case loads in prior years had made it difficult for APA team leaders to give adequate attention to all pending cases. As set forth in Table 1 below, new APA filings declined by 15% to 77 as compared to 91 in the prior year.

APA New Hire Training

In 2001, the APA Office greatly increased the size of its professional staff. To ensure the most immediate benefits from its new staff, provide the highest quality service to the program's customers, and increase the program's efficient use of its new resources, the APA Program worked with the Training and Communications Division of the Office of Associated Chief Counsel (Finance & Management) to develop an APA New Hire Training Program. The APA managers, senior Team Leaders and APA Economists participated in the training by developing a list of topics, preparing and reviewing course materials, and serving as class presenters.

The APA New Hire Training consisted of 19 three to four hour sessions presented throughout June, July, August, and September. The session topics included the history of the APA Program, general administrative matters, APA case management procedures, and substantive transfer pricing/APA topics.

The APA Office has released the written course materials to the public. These training materials and other APA related documents can be found at the IRS website, *www.irs.gov*, under an APA hyperlink under the Business/Corporate webpage. The APA Office will periodically update these training materials as appropriate.

APA West Coast Branch

In September 2001, the APA Program opened its new Branch 4 in California, implementing its plan to be more easily accessible to taxpayers located west of the Mississippi. Approximately 25% of APA caseload comes from such taxpayers, with the majority of these in California, divided almost evenly between Northern and Southern California. The APA Program determined that having Western cases serviced from California would benefit both taxpayers and APA staff by reductions in travel time, costs, and time zone complications, and by closer relations with Western taxpayers and taxpayer organizations.

The first of Branch 4's two planned offices is located in San Francisco and is already fully functional, staffed with a branch manager, three team leaders, and an economist. Numerous taxpayer representatives have contacted the office from its first days of operation; after six months, Branch 4 is handling a significant inventory of APA submissions and pre-filing conferences for Western cases. Plans for the second Branch 4 office are in the final stages. The office is expected to open during the first half of 2002 in Laguna Niguel in Orange County, about one hour south of Los Angeles. After hiring is complete, this office, like the San Francisco office, will have three team leaders and an economist. In addition, the branch chief of Branch 4 will be resident at the Southern California office, while continuing to manage the San Francisco office. The APA Program expects that its office in Southern California will meet with the same positive reaction among Western taxpayers, taxpayer organizations and their representatives that Branch 4's Northern California office is enjoying.

Model APA at Attachment A
[§ 521(b)(2)(B)]

Once the IRS and the Taxpayer reach agreement, the drafting of the final APA generally takes little time because the APA Program has developed model language. Attachment A contains the current version of this language. As part of its continuing effort to improve its work products, the APA Program has revised the model language to reflect the program's collective experience with substantive and drafting issues.

APA Program Statistical Data
[§ 521(b)(2)(C) and (E)]

The statistical information required under § 521(b)(2)(C) is contained in Tables 1 and 9 below; the information required under § 521(b)(2)(E) is contained in Tables 2 and 3 below:

TABLE 1: APA APPLICATIONS, EXECUTED APAs, and PENDING APAs

	Unilateral	Bilateral	Multilateral	Year Total	Cumulative Total
APA applications filed during year 2001	31	46		77	569
APAs executed					
•Year 2001	36	19		55	349
•1991–2000	143	144 [2]	7	294	
APA renewals executed during year 2001	14	2		16	70
Revised or Amended APAs executed during year 2001 [3]	6	1		7	12
Pending requests for APAs	40	177		217	
Pending requests for new APAs	34	132		166	
Pending requests for renewal APAs	6	45		51	
APAs canceled [4]	3	1		4	5
APAs withdrawn	1	4		5	54

TABLE 2: MONTHS TO COMPLETE APAs

Months to Complete Advance Pricing Agreements in Year 2001	
Combined Unilateral, Bilateral, Multilateral: Average	23.3
Combined Unilateral, Bilateral, Multilateral: Median	18.0

Unilateral New		Unilateral Renewal		Unilateral Combined	
Average	16.0	Average	18.1	Average	16.8
Median	15.5	Median	17.0	Median	16.0

Bilateral/Multilateral New		Bilateral/Multilateral Renewal		Bilateral/Multilateral Combined[5]	
Average	37.2	Average	21.0	Average	35.5
Median	42.0	Median	21.0	Median	42.0

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[2] One 1996 APA involving a US Possession is counted as a bilateral APA.

[3] In 2001, the APA Office and taxpayers agreed to amend 7 APAs (*i.e.*, six unilateral and one bilateral). Generally, the APA Office and taxpayers amended APAs to clarify the agreement. For example, five APA amendments related to: conforming the language of the APA to reflect the parties' agreement; conforming the language of the APA to the language of the mutual agreement letter; clarifying the definition of a term; clarifying non-covered transactions; and clarifying the length of the APA term. Failure to meet a critical assumption precipitated the amendment of two other APAs. In one of the APAs, the taxpayer failed to have minimum annual gross sales. In the other APA, the taxpayer reorganized its business.

[4] In the history of the APA Program, no APAs have been revoked. In 2001, the APA Office and taxpayers agreed to cancel 4 APAs (*i.e.*, three unilateral and one bilateral). The circumstances of these cancellations were the sale of the taxpayer's covered business operations, the failure of the taxpayer to have minimum covered transaction-related revenue, and the taxpayer's inability to operate due to equipment failure, and the takeover of the taxpayer resulting in a material change of its accounting systems.

[5] The average time required to conclude a bilateral APA has historically been split roughly equally between the APA and Competent Authority Offices.

TABLE 3: APA COMPLETION TIME – MONTHS PER APA

Months	Number of APAs	Months	Number of APAs	Months	Number of APAs	Months	Number of APAs
1	2	16	4	31	0	46	3
2	0	17	2	32	2	47	2
3	1	18	3	33	0	48	1
4	0	19	0	34	0	49	0
5	0	20	1	35	0	50	0
6	2	21	0	36	0	51	0
7	1	22	0	37	0	52	0
8	3	23	4	38	0	53	0
9	3	24	2	39	0	54	0
10	1	25	0	40	0	55	0
11	2	26	0	41	0	56	2
12	1	27	2	42	5	57	0
13	2	28	0	43	0	58	0
14	1	29	1	44	1	59	0
15	1	30	0	45	0	60	0

TABLE 4: RECOMMENDED NEGOTIATING POSITIONS

Recommended Negotiating Positions Completed in Year 2001	43

TABLE 5: MONTHS TO COMPLETE RECOMMENDED NEGOTIATING POSITIONS

Combined		New		Renewal	
Average	25.6	Average	22.2	Average	30.0
Median	22.9	Median	17.8	Median	23.3

TABLE 6: RECOMMENDED NEGOTIATING POSITIONS COMPLETION TIME – MONTHS PER APA

Months	Number	Months	Number	Months	Number	Months	Number
1	0	26	0	51	0	76	0
2	0	27	2	52	1	77	0
3	0	28	0	53	0	78	0
4	2	29	0	54	0	79	0
5	0	30	0	55	0	80	0
6	0	31	0	56	0	81	0
7	0	32	0	57	0	82	0
8	0	33	1	58	0	83	0
9	1	34	1	59	0	84	0
10	1	35	0	60	1	85	0
11	2	36	0	61	0	86	0
12	1	37	1	62	0	87	0
13	1	38	0	63	0	88	0
14	7	39	1	64	0	89	0
15	2	40	0	65	0	90	0
16	0	41	0	66	0	91	0
17	0	42	0	67	0	92	0
18	1	43	1	68	0	93	1
19	0	44	1	69	0	94	0
20	1	45	0	70	0	95	0
21	0	46	0	71	0	96	0
22	4	47	1	72	0	97	0
23	4	48	1	73	0	98	0
24	1	49	0	74	0	99	0
25	2	50	0	75	0	100	0

TABLE 7: SMALL BUSINESS TAXPAYER APAs[6]

Small Business Taxpayer APAs Completed in Year 2001	11
Renewals	1
New	10
Unilateral	10
Bilateral	1

TABLE 8: MONTHS TO COMPLETE SMALL BUSINESS TAXPAYER APAs

Months to Complete Small Business Taxpayer APAs in Year 2001					
New		**Renewal**		**Combined**	
Average	15.4	Average	9.0	Average	14.8
Median	17.0	Median	9.0	Median	17.0

[6] A "small business taxpayer" is a U.S. taxpayer with a total gross income of $200 million or less, and the APA is processed under the special procedures set forth in Notice 98–65.

TABLE 9: INDUSTRIES COVERED

Industry Involved — NAICS Codes[7]	Number
Computer and electronic product manufacturing – 334	13–15
Machinery manufacturing – 333	4–6
Electrical equipment, appliance and component manufacturing – 335	4–6
Transportation equipment manufacturing – 336	4–6
Chemical manufacturing – 325	4–6
Wholesale trade, durable goods – 421	1–3
Securities, commodity contracts and other intermediary and related activities – 523	1–3
Apparel manufacturing – 315	1–3
Motor vehicle and parts dealers – 441	1–3
Air transportation – 481	1–3
Publishing industries – 511	1–3
Information service and data processing services – 514	1–3
Beverage and tobacco manufacturing – 312	1–3
Furniture and related products manufacturing – 337	1–3
Miscellaneous manufacturing – 339	1–3
Wholesale trade, nondurable goods – 422	1–3
Health and personal care stores – 446	1–3
Broadcasting and telecommunications – 513	1–3
Professional, scientific and technical services – 541	1–3

Trades or Businesses
[§ 521(b)(2)(D)(i)]

The nature of the relationship between the related organizations, trades, or businesses covered by APAs executed in Year 2001 are set forth in Table 10 below:

TABLE 10: NATURE OF RELATIONSHIPS BETWEEN RELATED ENTITIES

Relationship	Number of APAs
Foreign Parent – U.S. Subsidiary (-ies)	34
U.S. Parent – Foreign Subsidiary (-ies)	12
Foreign company and U.S. Branch (-es)	6
U.S. Company and Non-U.S. Branch (-es)	2
Partnership	1

Covered Transactions
[§ 521(b)(2)(D)(ii)]

The controlled transactions covered by APAs executed in Year 2001 are set forth in Table 11 and Table 12 below:

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[7] The categories in this table are drawn from the North American Industry Classification System (NAICS), which has replaced the U.S. Standard Industrial Classification (SIC) system. NAICS was developed jointly by the U.S., Canada, and Mexico to provide new comparability in statistics about business activity across North America.

TABLE 11: TYPES OF COVERED TRANSACTIONS

Transaction Type	Number
Sale of tangible property into the US	29
Performance of services by US entity	19
Performance of services by Non-US entity	11
Sale of tangible property from the US	10
Use of intangible property by US entity	8
Use of intangible property by Non-US entity	7
Financial products — US branch of foreign company	3
R&D cost sharing — Non-US parent	2
Other	4

TABLE 12: TYPES OF COVERED TRANSACTIONS – SERVICES

Intercompany Services Involved in the Covered Transactions	Number
Distribution	16
Marketing	9
Headquarters costs	8
Assembly	7
Product support	7
Sales support	6
Warranty services	6
Accounting	5
Administrative	5
Research and development	5
Technical support services	5
Billing services	3
Contract research & development	3
Purchasing	3
Testing and installation services	3
Communication service	2
Legal	2
Management	2
Logistical support	1
Other	4

Business Functions Performed and Risks Assumed
[§ 521(b)(2)(D)(ii)]

The general descriptions of the business functions performed and risks assumed by the organizations, trades, or businesses whose results are tested in the covered transactions in the APAs executed in Year 2001 are set forth in Tables 13 and 14 below:

TABLE 13: FUNCTIONS PERFORMED BY THE TESTED PARTY

Functions Performed	Number
Marketing and distribution functions	49
Manufacturing	20
Product assembly and/or packaging	14
Research and development	12
Transportation and warehousing	12
Product service (repairs, etc.)	12
Product design and engineering	10
Managerial, legal, accounting, finance, personnel, and other support services	10
Technical training and tech support for sales staff (including sub-distributors)	9
Process engineering	8
Product testing and quality control	7
Purchasing and materials management	6
Engineering and construction related services	3
Licensing of intangibles	2
Trading and risk management of financial products	2
Consulting services	1
Telecom services	1
Other	3

TABLE 14: RISKS ASSUMED BY THE TESTED PARTY

Risks Assumed	Number
Market risks, including fluctuations in costs, demand, pricing, & inventory	43
General business risks (*e.g.*, related to ownership of PP&E)	36
Credit and collection risks	29
Financial risks, including interest rates & currency	27
R&D risks	7
Product liability risks	7
Warranty replacement risk	1

Discussion

The vast majority of APAs have covered transactions that involve numerous business functions and risks. For instance, with respect to functions, companies that manufacture products have typically conducted research and development, engaged in product design and engineering, manufactured the product, marketed and distributed the product, and performed support functions such as legal, finance, and human resources services. Regarding risks, companies have been subject to market risks, R&D risks, financial risks, credit and collection risks, product liability risks, and general business risks. In the APA evaluation process a significant amount of time and effort is devoted to understanding how the functions and risks are allocated amongst the controlled group of companies that are party to the covered transactions.

In their APA proposals taxpayers are required to provide a functional analysis. The functional analysis identifies the economic activities performed, the assets employed, the economic costs incurred, and the risks assumed by each of the controlled parties. The importance of the functional analysis derives from the fact that economic theory posits that there is a positive relationship between risk and expected return and that different functions provide different value and have different opportunity costs associated with them. It is important that the functional analysis go beyond simply categorizing the tested party as, say, a distributor. It should provide more specific information since, in the example of distributors, not all distributors undertake similar functions and risks.

Thus, the functional analysis has been critical in determining the TPM (including the selection of comparables). Although functional comparability has been an essential factor in evaluating the reliability of the TPM (including the selection of comparables), the APA evaluation process has also involved consideration of economic conditions such as the economic condition of the particular industry.

In evaluating the functional analysis, the APA program has considered contractual terms between the controlled parties and the consistency of the conduct of the parties with respect to the allocation of risk. Per the § 482 regulations, the APA program also has given consideration to the ability of controlled parties to fund losses that might be expected to occur as the result of the assumption of a risk. Another relevant factor considered in evaluating the functional analysis is the extent to which each controlled party exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. The § 482 Regulations posit that parties at arm's length will ordinarily bear a greater share of those risks over which they have relatively more control.

Related Organizations, Trades, or Businesses Whose Prices or Results are Tested to Determine Compliance with APA Transfer Pricing Methods
[§ 521(b)(2)(D)(iii)]

The related organizations, trades, or businesses whose prices or results are tested to determine compliance with TPMs prescribed in APAs executed in Year 2001 are set forth in Table 15 below:

TABLE 15: RELATED ORGANIZATIONS, TRADES, OR BUSINESSES WHOSE PRICES OR RESULTS ARE TESTED

Type of Organization	Number[8]
US distributor	31
US provider of services	11
Non-US distributor	9
Non-US manufacturer	6
Non-US provider of services	6
US licensee of intangible property	6
US manufacturer	5
Non-US licensee of intangible property	5
US licensor of intangible property	4
US dealer in financial products	2
US participant in cost sharing agreement	2
Non-US participant in cost sharing agreement	2
Non-US licensor of intangible property	1
Non-US dealer in financial products	1

Transfer Pricing Methods and the Circumstances Leading to the Use of Those Methods
[§ 521(b)(2)(D)(iv)]

The TPMs used in APAs executed in Year 2001 are set forth in Tables 16–20 below:

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[8] For purposes of this report, both sides are counted as tested parties for certain transactions, such as those involving the use of the Comparable Uncontrollod Price, Comparable Uncontrolled Transaction, profit split methods, as well as cost sharing agreements.

TABLE 16: TRANSFER PRICING METHODS USED FOR TRANSFERS OF TANGIBLE AND INTANGIBLE PROPERTY

TPM used	Number[9]
Comparable Profits Method (CPM): PLI is operating margin	22
Comparable Profits Method (CPM): PLI is Berry ratio	7
CUT (intangibles only)	6
Comparable Profits Method (CPM): PLI is markup on total costs	6
Transactional Cost Plus Method (tangibles only)	5
Royalty implementing a CUT TPM	5
Royalty implementing a residual profit split TPM	5
Transactional Resale Price Method (tangibles only)	4
Royalty implementing a profit split TPM	3
Comparable Profits Method (CPM): PLI is Other	3
Unspecified method (except unspecified profit split)	2
Residual profit split	2
CUP (tangibles only) not based on published market data	1
Other profit split	1
Comparable Profits Method (CPM): PLI is return on assets or capital employed	1
Comparable Profits Method (CPM): PLI is gross margin	1
Comparable Profits Method (CPM): PLI is markup on other costs	1

TABLE 17: TRANSFER PRICING METHODS USED FOR SERVICES

TPM used	Number[10]
Cost plus a markup	13
CPM: PLI is operating margin	5
CPM: PLI is markup on total costs	4
Cost with no markup	4

TABLE 18: TRANSFER PRICING METHODS USED FOR FINANCIAL PRODUCTS

TPM used	Number
Interbranch allocation (*e.g.*, foreign exchange separate enterprise with statistical test of interbranch trades)	3

TABLE 19: TRANSFER PRICING METHODS USED FOR CONTRIBUTIONS TO COST SHARING ARRANGEMENTS

TPM used	Number
Costs allocated based on units produced, used, or sold	1
Cost allocated based on cost of raw materials	1

[9] Profit Level Indicators ("PLIs") used with the Comparable Profit Method of Treas. Reg. § 1.482–5, and as used in these TPM tables, are as follows: (1) rate of return on assets or capital employed is the ratio of operating profit to operating assets, (2) operating margin is the ratio of operating profit to sales, (3) gross margin is the ratio of gross profit to sales, (4) Berry ratio is the ratio of gross profit to operating expenses, and (5) markup on total costs is generally a comparative markup on total costs involved.

[10] Some of the service transactions were covered by the transfer pricing methods used in tangible/intangible property transactions.

TABLE 20: TRANSFER PRICING METHODS USED FOR COST SHARING BUY-IN PAYMENTS

TPM used	Number
Buy-in based on residual profit split	1
Buy-in based on capitalized R&D	1

Discussion

The transfer pricing methods used in APAs completed during Year 2001 were based on those in the § 482 Treasury Regulations. Under § 1.482–3, the arm's length amount for controlled transfers of tangible property are determined using the Comparable Uncontrolled Price (CUP) method, the Resale Price Method, the Cost Plus Method, the Comparable Profits Method (CPM), and the Profit Split method. Under § 1.482–4, the arm's length amount for controlled transfers of intangible property are determined using the Comparable Uncontrolled Transaction (CUT) method, CPM, and the Profit Split Method. An "Unspecified Method" may be used for both tangible and intangible property if it provides a more reliable result than the enumerated methods under the best method rule of § 1.482–1(c). For transfers involving the provision of services, § 1.482–2(b) provides that services performed for the benefit of another member of a controlled group should ordinarily bear an arm's length charge, either deemed to be equal to the cost of providing the services (when non-integral) or which should be an amount that would have been charged between independent parties.

In addition, § 1.482–2(a) provides rules concerning the proper treatment of loans or advances, and § 1.482–7 provides rules for qualified cost sharing arrangements under which the parties agree to share the costs of development of intangibles in proportion to their shares of reasonably anticipated benefits. APAs involving cost sharing arrangements generally address both the method of allocating costs among the parties as well as determining the appropriate amount of the "buy-in" payment due for the transfer of intangibles to the controlled participants.

In reviewing the TPMs applicable to transfers of tangible and intangible property reflected in Table 16, it is clear that the majority of the APAs followed the specified methods. However, there are several distinguishing points that should be made. The Regulations note that for transfers of tangible property, the Comparable Uncontrolled Price (CUP) method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction when sufficiently reliable comparable transactions can be identified. § 1.482–3(b)(2)(ii)(A). It was the experience of the APA Program in Year 2001 that in the cases that come into the APA Program, sufficiently reliable CUP transactions are difficult to find. In APAs executed in Year 2001, there was only one APA that used the CUP method; it did not look to published market data in setting the arm's length price.

Similar to the CUP method, for transfers of intangible property, the CUT method will generally provide the most reliable measure of an arm's length result when sufficiently reliable comparables may be found. § 1.482–4(c)(2)(ii). It has generally been difficult to identify external comparables, and APAs using the CUT method tend to rely on internal transactions between the taxpayer and unrelated parties. In Year 2001, there were six APAs that utilized the CUT method, and four of those also used one or more other methods for different covered transactions by the same taxpayer in the same APA.

The transactional Cost Plus Method (tangibles only) and Resale Price Method were applied in Year 2001 in five and four APAs respectively. See § 1.482–3(c), (d). The transactional nature of these methods distinguishes them from the CPM method using either a gross margin PLI (as compared to the Resale Price Method) or a markup on total costs PLI (as compared to the Cost Plus Method). A strict transactional method focuses on prices for individual or narrow groups of transactions, while a CPM looks at profits from broader groups of transactions or all of a company's transactions. In Year 2001, only two of the Cost Plus Method APAs used that method alone. The other three APAs using this method were supplemented by a CPM. In Year 2001, only two of the Resale Price Method APAs used that method alone. The other two APAs using this method were supplemented by a CPM.

The CPM is frequently applied in APAs. This is because reliable public data on comparable business activities of independent companies may be more readily available than potential CUP data, and comparability of resources employed, functions, risks, and other relevant considerations is more likely to exist than comparability of product. The CPM also tends to be less sensitive than other methods to differences in accounting practices between the tested party and comparable companies, *e.g.* classification of expenses as cost of goods sold or operating expenses. § 1.482–3(c)(3)(iii)(B), and –3(d)(3)(iii)(B). In addition, the degree of functional comparability required to obtain a reliable result under the CPM is generally less than required under the resale price or cost plus methods, because differences in functions performed often are reflected in operating expenses, and thus taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit. § 1.482–5(c)(2).

There were 39 covered transactions involving tangible or intangible property that used some form of the CPM (with varying PLIs). The CPM was also used in some APAs concurrently with other methods. For example, the CPM was used with two out of the four APAs that used the resale price method.

The CPM has proven to be versatile in part because of the various PLIs that can be used in connection with the method. Reaching agreement on the appropriate PLI has been the subject of much discussion in many of the cases, and it depends heavily on the facts and circumstances. Some APAs have called for different PLIs to apply to different parts of the covered transactions or with one PLI used as a check against the primary PLI. In two covered transactions, an operating margin PLI was used in conjunction with another PLI, the markup on total costs.

The CPM also was used regularly with services as the covered transactions in APAs executed in Year 2001. There were a total of nine services covered transactions using the CPM method with various PLIs according to the specific facts of the taxpayers involved. Table 17 reflects the methods used to determine the arm's length results for APAs involving services transactions.

In Year 2001, there were two APAs involving tangible or intangible property that used some form of a profit split. Both APAs used the Residual Profit Split, § 1.482–6(c)(3), in which routine contributions by the controlled parties are allocated routine market returns, and the residual income is allocated among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity. One of those APAs also used a second type of profit split. Profit splits are generally considered in cases in which the parties to the controlled transaction own valuable, non-routine, intangible property.

There were three financial product APAs involving interbranch allocations. These involve a single taxpayer with branches that act autonomously with respect to the covered transactions, generally involving foreign currency exchanges. These particular APAs determine the appropriate amount of profits attributable to each branch from the activity by reference to the branches' internal accounting methods. The results take into account all trades, and test the arms length results using statistical tests to verify that controlled trades are priced the same as uncontrolled trades.

There were two cost sharing APAs during Year 2001. Cost sharing APAs under § 1.482–7 generally address the methods used for determining each participant's share of costs (consistent with the reasonably anticipated benefits) for the development of intangibles. When there is also the transfer of existing intangibles, the APA will also generally address the appropriate buy-in amount. Tables 19 and 20 reflect the methods applied in cost sharing APAs executed in Year 2001.

Critical Assumptions
[§ 521(b)(2)(D)(v)]

Critical Assumptions used in APAs executed in Year 2001 are described in Table 21 below:

TABLE 21: CRITICAL ASSUMPTIONS

Critical Assumptions involving the following:	Number of APAs
Material changes to the business	55
Material changes to tax and/or financial accounting practices	55
Assets will remain substantially same	17
Changes in affiliated companies	14
Catastrophic events	5
Major regulatory changes	4
Use of Mark-to-Market method	3
Minimum sales volume	3
Changes in market shares	3
Major contract remains in force	3
Other financial ratio	3
Changes in sharing of risks of currency fluctuations	2
Interest rate changes	2
Material sales fluctuations	2
Marketing conditions substantially same	2
New import/ export non-tariff barriers	2
Ratio of R&D to sales	2
Currency fluctuations	1
Sales territories substantially same	1
Changes involving anti-dumping/ countervailing duties	1
Changes in other duties or tariffs	1
Major technological changes	1
Licensing agreements remain in effect	1
Other	11

Discussion

APAs include critical assumptions upon which their respective TPMs depend. Critical assumptions are objective business and economic criteria that form the basis of a taxpayer's proposed TPM. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume. Rev. Proc. 96–53, § 5.07. Failure to meet a critical assumption may render an APA inappropriate or unworkable.

A critical assumption may change (and/or fail to materialize) due to uncontrollable changes in economic circumstances, such as a fundamental and dramatic change in the economic conditions of a particular industry. In addition, a critical assumption may change (and/or fail to materialize) due to a taxpayer's actions that are initiated for good faith business reasons, such as a change in business strategy, mode of conducting operations, or the cessation or transfer of a business segment or entity covered by the APA.

If a critical assumption has not been met, the APA may be revised by agreement of the parties. If such agreement cannot be achieved, the APA may be canceled. If a critical assumption has not been met, it requires taxpayer's notice to and discussion with the Service, and, in the case of a bilateral APA, Competent Authority consideration. Rev. Proc. 96–53, § 11.07.

Sources of Comparables, Selection Criteria, and the Nature of Adjustments to Comparables and Tested Parties
[§ 521(b)(2)(D)(v), (vi), and (vii)]

The sources of comparables, selection criteria, and rationale used in determining the selection criteria for APAs executed in Year 2001 are described in Tables 22 through 24 below. Various formulas for making adjustments to comparables are included as Attachment B.

TABLE 22: SOURCES OF COMPARABLES

Comparable Sources	Number of Times This Source Used [11]
Compustat	39
Disclosure	13
Moody's	2
Japan Company Handbook	1
Global Vantage	1
Taxpayer's information on competition	1
Other	9

TABLE 23: COMPARABLE SELECTION CRITERIA

Selection Criteria Considered	Number of Times This Criterion Used
Comparable functions	46
Comparable industry	36
Comparable risks	31
Comparable products	27
Comparable geographic market	13
Comparable intangibles	11
Contractual terms	3
Other	4

TABLE 24: ADJUSTMENTS TO COMPARABLES OR TESTED PARTIES

Adjustment	Number of Times This Adjustment Used
Asset intensity adjustments	34
Receivables	34
Inventory	33
Payables	33
Property, plant, equipment	6
Other	2
Accounting adjustments	8
LIFO to FIFO inventory accounting	7
Accounting reclassifications (*e.g.*, from COGS to operating expenses)	2
Other	1
Profit level indicator adjustments (used to "back into" one PLI from another)	7
Operating expense	5
Other	2
Miscellaneous adjustments	3
Advertising	1
Other	2

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[11] Although still guided by the arm's length standard, some APAs do not use comparables, for example, when there is a residual profit or in the case of certain financial products.

Discussion

At the core of most APAs are comparables. The APA program works closely with taxpayers to find the best and most reliable comparables for each covered transaction. In some cases, CUPs or CUTs can be identified. In other cases, comparable business activities of independent companies are utilized in applying the CPM or residual profit split methods. Generally, in the APA Program's experience since 1991, CUPs and CUTs have been most often derived from the internal transactions of the taxpayer.

For profit-based methods in which comparable business activities or functions of independent companies are sought, the APA Program typically has applied a three-part process. First, a pool of potential comparables has been identified through broad searches. From this pool, companies having transactions that are clearly not comparable to those of the tested party have been eliminated through the use of quantitative and qualitative analyses, *i.e.*, quantitative screens and business descriptions. Then, based on a review of available descriptive and financial data, a set of comparable companies or transactions has been finalized. The comparability of the finalized set has then been enhanced through the application of adjustments.

Sources of Comparables

Comparables used in APAs can be U.S. or foreign companies. This depends on the relevant market, the type of transaction being evaluated, and the results of the functional and risk analyses. In general, comparables have been located by searching a variety of databases that provide data on U.S. publicly traded companies and on a combination of public and private non-U.S. companies. Table 22 shows the various databases and other sources used in selecting comparables for the APAs executed in Year 2001.

Although comparables were most often identified from the databases cited in Table 22, in some cases comparables were found from other sources, such as comparables derived internally from taxpayer transactions with third parties and comparables derived from taxpayer information on competitors.

Selecting Comparables

Initial pools of potential comparables generally have been derived from the databases using a combination of industry and keyword identifiers. Then, the pool has been refined using a variety of selection criteria specific to the transaction or entity being tested and the transfer pricing method being used.

The listed databases allow for searches by industrial classification (generally, U.S. Standard Industrial Classification (SIC)), by keywords, or by both. These searches can yield a number of companies whose business activities may or may not be comparable to those of the entity being tested. Therefore, comparables based solely on SIC or keyword searches are rarely used in APAs. Instead, the pool of comparables is examined closely, and companies are selected based on a combination of screens, business descriptions, and other information found in the companies' Annual Reports to shareholders and filings with the U.S. Securities and Exchange Commission (SEC).

Business activities are required to meet certain basic comparability criteria to be considered comparables. Functions, risks, economic conditions, and the property (product or intangible) and services associated with the transaction must be comparable. Determining comparability can be difficult — the goal has been to use comparability criteria restrictive enough to eliminate companies that are not comparable, but yet not so restrictive as to have no comparables remaining. The APA Program normally has begun with relatively strict comparability criteria and then has relaxed them slightly if necessary to derive a pool of reliable comparables. A determination on the appropriate size of the comparables set, as well as the companies that comprise the set, is highly fact specific and depends on the reliability of the results.

In addition, the APA Program, consistent with the regulations, generally has looked at the results of comparable companies over a multi-year period. Sometimes this has been three years, but it has been more or less, depending on the circumstances of the controlled transaction. Using a shorter period might result in the inclusion of companies in different stages of economic development or use of atypical years of a company subject to cyclical fluctuations in business conditions.

Many covered transactions have been tested with comparables that have been chosen using additional criteria and/or screens. These include sales level criteria and tests for financial distress and product comparability. These common selection criteria and screens have been used to increase the overall comparability of a group of companies and as a basis for further research. The sales level screen, for example, has been used to remove companies that, due to their size, might face fundamentally different economic conditions from those of the entity or transaction being tested. In addition, some APA analyses have incorporated selection criteria related to removing companies experiencing "financial distress" due to concerns that companies in financial distress often have experienced unusual circumstances that would render them not comparable to the entity being tested. These criteria include: an unfavorable auditor's opinion, bankruptcy, and in certain circumstances, operating losses in a given number of years.

An additional important class of selection criteria is the development and ownership of intangible property. In some cases in which the entity being tested is a manufacturer, several criteria have been used to ensure, for example, that if the controlled entity does not own significant manufacturing intangibles or conduct research and development (R&D), neither will the comparables. These selection criteria have included determining the importance of patents to a company or screening for R&D expenditures as a percentage of sales or costs. Another criterion used in some cases has been a comparison of the book and market values of a company; this can be another indicator of intangible value. Again, quantitative screens related to identifying comparables with significant intangible property generally have been used in conjunction with an understanding of the comparable derived from publicly available business information.

Selection criteria relating to asset comparability and operating expense comparability have also been used at times. A screen of property, plant, and equipment (PP&E) as a percentage of sales or assets, combined with a reading of a company's SEC filings, has been used to help ensure that distributors (generally lower PP&E) were not compared with manufacturers (generally higher PP&E), regardless of their SIC classification. Similarly, a test involving the ratio of operating expenses to sales or total costs has helped to determine whether a company undertakes a significant marketing and distribution function.

Table 25 shows the number of times various screens were used in APAs executed in Year 2001:

TABLE 25: COMPARABILITY SCREENS

Comparability Screen Used	Number of Times Used
Comparability screens used	—
Sales	18
Operating expenses/ sales	12
Non-startup or start-up	12
R&D/ sales	8
Foreign sales/ total sales	3
Financial distress	—
Bankruptcy	15
SG&A/ sales	7
Unfavorable auditor's opinion	7
Losses in Three Years	5
Losses in Two Years	3
PP&E/ sales	1

Adjusting Comparables

After the comparables have been selected, the regulations require that "[i]f there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results." Treas. Reg. § 1.482–1(d)(2). In almost all cases involving income-statement-based profit level indicators (PLIs), certain "asset intensity" or "balance sheet" adjustments for factors that have generally agreed-upon effects on profits have been carried out. In addition, in specific cases, additional adjustments have been performed to improve reliability.

The most common asset intensity adjustments used in APAs are adjustments for differences in accounts receivable, inventories, and accounts payable. The APA Program generally has required adjustments for receivables, inventory, and payables based on the principle that holding assets such as receivables benefits customers in a way that increases the entity's operating profit. Such adjustments are based on the assumption that the increase in operating profit is equal to the carrying cost of the assets. Conversely, the holding of accounts payable is considered to burden suppliers in a way that decreases the entity's profit. The decrease in operating profit has generally been assumed to be equal to the cost of funds implicitly borrowed from suppliers.

To compare the profits of two entities with different relative levels of receivables, inventory, or payables, the APA Program has estimated the carrying costs of each item and adjusted profits accordingly. Although different formulas have been used in specific APA cases, Attachment B presents one set of formulas used in many APAs. Underlying these formulas are the notions that (1) balance sheet items should be expressed as mid-year averages, (2) formulas should try to avoid using data items that are being tested

by the transfer pricing method (for example, if sales are controlled, then the denominator of the balance sheet ratio should not be sales), (3) a short term interest rate should be used, and (4) an interest factor should recognize the average holding period of the relevant asset.

The APA Program has also required that data must be compared on a first-in first-out (FIFO) accounting basis. Although financial statements may be prepared on a last-in first-out (LIFO) basis, cross-company comparisons are less meaningful when one or more companies use LIFO inventory accounting methods. This adjustment directly affects costs of goods sold and inventories, and therefore affects both profitability measures and inventory adjustments.

Less commonly used but still important in some cases is the adjustment for differences in relative levels of PP&E between a tested entity and the comparables. Ideally, comparables and the entity being tested will have fairly similar relative levels of PP&E, since major differences can be a sign of fundamentally different functions and risks. Typically, the PP&E adjustment is made using a medium term interest rate, while short-term interest rates are used for receivables, inventories, and payables.

Additional adjustments used less infrequently include those for differences in other balance sheet items, operating expenses, R&D, or currency risk. Accounting adjustments, such as reclassifying items from cost of goods sold to operating expenses, for example, have also been made when warranted to increase reliability. Often, data has not been available for both the controlled and uncontrolled transactions in sufficient detail to allow for these types of adjustments.

The adjustments made to comparables or tested parties in APAs executed in Year 2001 are reflected in table 24 above.

Nature of Ranges and Adjustment Mechanisms
[§ 521(b)(2)(D)(viii)–(ix)]

The types of ranges used in APAs executed in Year 2001 are described in Tables 26 and 27 below.

TABLE 26: TYPES OF RANGES

Type of Range	Number [12]
Interquartile range	23
Floor (*i.e.*, result must be no less than x)	8
Specific point within CPM range	7
Specific point (royalty)	6
Financial products – statistical confidence interval to test against internal cups	3
Ceiling (*i.e.*, result must be no more than x)	3
Full range	1
Specific point (CUP)	1
Other	1

TABLE 27: ADJUSTMENTS WHEN OUTSIDE OF THE RANGE

Adjustment Mechanism	Number
Taxpayer makes an adjustment: to closest edge	15
Taxpayer makes an adjustment: to specified point	14
Competent Authority process invoked if results are outside the range	5
Taxpayer makes an adjustment: to median	4
Other	7

[12] Numbers do not include TPMs with cost or cost-plus methodologies.

Discussion

Treas. Reg. § 1.482–1(e)(1) states that sometimes a pricing method will yield "a single result that is the most reliable measure of an arm's length result." Sometimes, however, a method may yield "a range of reliable results," called the "arm's length range." A taxpayer whose results fall within the arm's length range will not be subject to adjustment.

Under § 1.482–1(e)(2)(i), such a range is normally derived by considering a set of more than one comparable uncontrolled transaction of similar comparability and reliability. If these comparables are of very high quality, as defined in the Regulations, then under § 1.482–1(e)(2)(iii)(A), the arm's length range includes the results of all of the comparables (from the least to the greatest). However, the APA Program has only rarely identified cases meeting the requirements for the full range. There was one APA executed in Year 2001 that used a full range. If the comparables are of lesser quality, then under § 1.482–1(e)(2)(iii)(B), "the reliability of the analysis must be increased, when it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables." One such method, the "interquartile range," is "ordinarily . . . acceptable," although a different statistical method "may be applied if it provides a more reliable measure." The "interquartile range" is defined as, roughly, the range from the 25th to the 75th percentile of the comparables' results. See § 1.482–1(e)(2)(iii)(C). The interquartile range was used 23 times in Year 2001.

In fourteen APAs executed in Year 2001, the APA specified a single, specific result, or "point." Seven of these APAs involved a CPM in which the taxpayer agreed to a specific result. Some APAs specify not a point or a range, but a "floor" or a "ceiling". When a floor is used, the tested party's result must be greater than or equal to some particular value. When a ceiling is used, the tested party's result must be less than or equal to some particular value. Eight APAs executed in Year 2001 used a floor and three used a ceiling.

Some APAs involving financial products have employed a statistical confidence interval to compare pricing of a large set of controlled transactions with a comparable set of uncontrolled transactions. A statistical confidence interval is typically applied to a financial institution with autonomous branches in several countries. Pursuant to the business profits article of the applicable income tax treaties and Prop. Reg. § 1.482–8(b), APAs have been executed allowing the taxpayer to allocate profits between branches with reference to the branches' internal accounting methods, taking into account all trades, including interbranch and/or interdesk trades. In order for this method to provide a reliable result, however, it is necessary to ensure that all such controlled trades be priced on the same market basis as uncontrolled trades. To test whether this is so, a branch's controlled trades are matched with that branch's comparable uncontrolled trades made at times close to the controlled trades. A statistical test is performed to detect pricing bias, by which the controlled trades might as a whole be priced higher or lower than the uncontrolled trades. This has been accomplished by construction of a statistical confidence interval (typically 95%), with the tested hypothesis being that controlled trades are priced on the same basis as uncontrolled trades. An adjustment is necessary if the results of the controlled trades fall outside of this confidence interval. During Year 2001, there were three APAs executed that employed the statistical confidence interval.

Some APAs look to a tested party's results over a period of years (multi-year averaging) to determine whether a taxpayer has complied with the APA. In 2001, rolling multi-year averaging was used for 11 covered transactions. Three of those used two-year averages, and the other eight used three-year averages. Cumulative multi-year averages were used for 18 covered transactions. Of those 18 transactions, four used two-year averages, three used three-year averages,[13] two used four-year averages, four used five-year averages, one used a six-year average, one used a seven-year average, two used nine-year averages, and one used a ten-year average.

Adjustments

Under § 1.482–1(e)(3), if a taxpayer's results fall outside the arm's length range, the Service may adjust the result "to any point within the arm's length range." Accordingly, an APA may permit or require a taxpayer and its related parties to make an adjustment after the year's end to put the year's results within the range, or at the point, specified by the APA. Similarly, to enforce the terms of an APA, the Service may make such an adjustment. When the APA specifies a range, the adjustment is sometimes to the closest edge of the range, and sometimes to another point such as the median of the interquartile range. Depending on the facts of each case, such automatic adjustments are not always permitted. Some bilateral APAs specify that in such a case there will be a negotiation between the Competent Authorities involved to determine whether and to what extent an adjustment should be made. Some APAs permit automatic adjustments unless the result is far outside the range specified in the APA. Thus they provide flexibility and efficiency (permitting adjustments when normal business fluctuations and uncertainties push the result somewhat outside the range).

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[13] One of the three-year cumulative averages applied a three-year cumulative average twice, once at the end of year three and once at the end of year six. A second covered transaction that used a three-year cumulative average also used a five-year cumulative average at the end of five years. To avoid double counting, that covered transaction is not included in the count of covered transactions using five-year averages.

In order to conform the taxpayer's books to these tax adjustments, the APA usually permits a "compensating adjustment" as long as certain requirements are met. Such compensating adjustments may be paid between the related parties with no interest, and the amount transferred will not be considered for purposes of penalties for failure to pay estimated tax. See § 11.02, Rev. Proc. 96–53.

APA Term and Rollback Lengths
[§ 521(b)(2)(D)(x)]

The various term lengths for APAs executed in Year 2001 are set forth in Table 28 below:

TABLE 28: TERMS OF APAs

APA Term in Years	Number of APAs
1	1
2	1
3	5
4	7
5	30
6	5
7	0
8	2
9	3
10	1

Number of rollback years to which an APA TPM was applied in Year 2001 are set forth in Table 29 below:

TABLE 29: NUMBER OF YEARS COVERED BY ROLLBACK OF APA TPM

Number of Rollback Years	Number of APAs
1	2
2	7
3	3
4	1
5 or more	2

Nature of Documentation Required
[§ 521(b)(2)(D)(xi)]

APAs executed in Year 2001 required that various documents be provided with the Annual Reports filed by the taxpayers. These documents are described in Table 30 below:

TABLE 30: NATURE OF DOCUMENTATION REQUIRED

Documentation	Number of Times This Documentation Required [14]
Statement identifying all material differences between Taxpayer's business operations during APA Year and description of Taxpayer's business operations contained in Taxpayer's request for APA, or if there have been no such material differences, a statement to that effect	55
Statement identifying all material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for APA, or if there have been none, statement to that effect	55
Financial analysis demonstrating Taxpayer's compliance with TPM	55
Description of any failure to meet Critical Assumptions or, if there have been none, a statement to that effect	55
Description of, reason for, and financial analysis of, any Compensating Adjustments with respect to APA Year, including means by which any Compensating Adjustment has been or will be satisfied	53
Financial statements as prepared in accordance with US GAAP	47
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its operations, in accordance with US GAAP	47
United States income tax return	14
Financial statements as prepared in accordance with foreign GAAP	8
Certified public accountant's opinion that financial statements present fairly financial position of Taxpayer and the results of its perations, in accordance with foreign GAAP	8
Profit & Loss statement	8
Schedule of costs and expenses (*e.g.*, intercompany allocations)	8
Various workpapers	6
Certified public accountant's review of financial statements	6
Book to tax reconciliations	6
Form 5471 or 5472	4
Organizational chart	4
Description of any matters economically or substantively related to the covered transactions, but that are not subject to the APA	4
Cash Flow statement	3
Pertinent intercompany agreements	2
Narrative description of taxpayer's business	1
Other	17

Approaches for Sharing of Currency or Other Risks

[§ 521(b)(2)(D)(xii)]

During Year 2001, there were 27 tested parties that faced financial risks, including interest rate and currency risks. One case that explicitly addressed currency risk adjusted a resale price interquartile range by a currency adjustment factor.

Efforts to Ensure Compliance with APAs

[§ 521(b)(2)(F)]

As described in Rev. Proc. 96–53, section 11, APA taxpayers are required to file annual reports to demonstrate compliance with the terms and conditions of the APA. The filing and review of annual reports is a critical part of the APA process. Through annual report review, the APA program monitors taxpayer compliance with the APA on a contemporaneous basis. Annual report review provides current information on the success or problems associated with the various TPMs adopted in the APA process.

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[14] The first seven categories of documentation listed in this table were drawn from the standard APA language used in 2001. In some financial product APAs, the taxpayer agrees to maintain certain records, but the compliance with the TPM is determined by a later audit under an agreed statistical methodology. In these cases, some of the standard documentation requirements may not be appropriate.

All reports received by the APA Office are tracked by one designated APA team leader who also has the prime responsibility for annual report review. Other APA team leaders also assist in this review, especially when the team leader who negotiated the case is available, since that person will already be familiar with the relevant facts and terms of the agreement. Once received by the APA Office, the annual report is sent out to the district personnel with exam jurisdiction over the taxpayer. This process changed in November 2001; previously reports were held until reviewed by an APA team leader. This change has facilitated simultaneous review of the reports and allowed the APA office to eliminate much of the backlog of annual reports.

The statistics for the review of APA annual reports are reflected in Table 31 below. As of December 31, 2001, there were 187 pending annual reports. In Year 2001, there were 320 reports closed.

TABLE 31: STATISTICS OF ANNUAL REPORTS

Number of APA annual reports pending as of December 31, 2001	187
Number of APA annual reports closed in Year 2001	320
Number of APA annual reports requiring adjustment in Year 2001	7
Number of taxpayers involved in adjustments	3
Number of APA annual reports required to be filed in Year 2001	252
Number of APA annual reports actually filed in Year 2001	207 [15]
Number of APA annual report cases over one year old	84

[15] Many of the reports that were due in Year 2001, but not received by Dec. 31, 2001, were timely filed but held up as a result of the new screening procedures of the mail.

ATTACHMENT A

ADVANCE PRICING AGREEMENT
between
[*Insert Taxpayer's Name*]
and
THE INTERNAL REVENUE SERVICE

PARTIES

The Parties to this Advance Pricing Agreement (APA) are the Internal Revenue Service (IRS) and [*Insert Taxpayer's Name*], EIN ________ (Taxpayer).

RECITALS

Taxpayer's principal place of business is [*City, State*]. [*Insert general description of taxpayer and other relevant parties.*]

This APA contains the Parties' agreement on the best method for determining arm's-length prices of the Covered Transactions under I.R.C. section 482 and the Treasury Regulations.

Unless otherwise specified, terms in the plural include the singular and vice versa. Appendix D contains definitions for capitalized terms not elsewhere defined in this APA.

{*If renewal, add*} [Taxpayer and IRS previously entered into an APA covering taxable years ending _______ to _______, executed on _________.]

AGREEMENT

The Parties agree as follows:

1. *Covered Transactions*. This APA applies to the Covered Transactions, as defined in Appendix A.

2. *Transfer Pricing Method*. Appendix A sets forth the Transfer Pricing Method (TPM) for the Covered Transactions.

3. *Term*. This APA applies to Taxpayer's taxable years ending __________ through ________(APA Term).

4. *Operation*.

a. Revenue Procedure 96–53 governs the interpretation, legal effect, and administration of this APA.

b. Nonfactual oral and written representations, within the meaning of sections 10.04 and 10.05 of Rev. Proc. 96–53 (including any proposals to use particular TPMs), made in conjunction with this request constitute statements made in compromise negotiations within the meaning of Rule 408 of the Federal Rules of Evidence.

5. *Compliance*.

a. For each taxable year covered by this APA (APA Year), if Taxpayer complies with the terms and conditions of this APA, then the IRS will not make or propose any allocation or adjustment under I.R.C. section 482 to the Covered Transactions.

b. If Taxpayer does not comply, then the IRS may:

i. enforce the terms and conditions of this APA and make or propose allocations or adjustments under I.R.C. section 482 consistent with this APA;
ii. cancel or revoke this APA under Revenue Procedure 96–53, section 11.05 or 11.06; or
iii. revise this APA, if the Parties agree.

c. Taxpayer must timely file an Annual Report for each APA Year in accordance with Appendix C and section 11.01 of Rev. Proc. 96–53. The IRS may request additional information reasonably necessary to clarify the Annual Report or verify compliance with the APA. Taxpayer will provide all requested information within a reasonable time.

d. The IRS will determine whether Taxpayer has complied with this APA based on Taxpayer's U.S. Returns, Financial Statements, and other APA Records, for the APA Term and any other year necessary to verify compliance. For Taxpayer to comply with this APA, an independent certified public accountant must {*use the following or an alternative*} render an opinion that the Taxpayer's Financial Statements present fairly, in all material respects, Taxpayer's financial position under U.S. GAAP.

e. In accordance with section 11.04 of Rev. Proc. 96–53, Taxpayer will (1) maintain its APA Records, and (2) make them available to IRS in connection with an examination under section 11.03. Compliance with this subparagraph constitutes compliance with the record-maintenance provisions of I.R.C. sections 6038A and 6038C for the Covered Transactions for any taxable year during the APA Term.

f. If Taxpayer's actual transactions do not result in compliance with the TPM, Taxpayer:

i. Must report its taxable income in an amount that is consistent with the TPM and all other requirements of this APA on its timely filed U.S. Return. However, for any APA Year, if Taxpayer's timely filed U.S. Return is filed no later than 60 days after the effective date of this APA, then Taxpayer may instead report its taxable income in an amount that is consistent with the TPM and all other requirements of this APA on an amended U.S. Return filed no later than 120 days after the effective date of this APA.

ii. May make compensating adjustments under Revenue Procedure 96–53, section 11.02, subject to any modifications or restrictions in Appendix A or elsewhere in this APA.

g. *{Insert when U.S. Group or Foreign Group contains more than one member.}* [This APA addresses the arm's-length nature of prices charged or received in the aggregate between Taxpayer[s] and Foreign Participants. Except as explicitly provided, this APA does not address and does not bind the IRS with respect to prices charged or received, or the relative amounts of income or loss realized, by particular legal entities that are members of U.S. Group or that are members of Foreign Group.]

h. The True Taxable Income within the meaning of Treasury Regulations section 1.482–1(a)(1) of a member of an affiliated group filing a U.S. consolidated return will be determined under the I.R.C. section 1502 Treasury Regulations.

i. *{Optional for US Parent Signatories}* To the extent that Taxpayer's compliance with this APA depends on certain acts of Foreign Group members, Taxpayer will ensure that each Foreign Group member will perform such acts.

6. *Critical Assumptions*. This APA's critical assumptions, within the meaning of Revenue Procedure 96–53, section 5.07, appear in Appendix B. Revenue Procedure 96–53, section 11.07, governs if any critical assumption has not been met.

7. *Disclosure*. This APA, and any background information related to this APA or the APA Request, are: (1) considered "return information" under I.R.C. section 6103(b)(2)(C); and (2) not subject to public inspection as a "written determination" under I.R.C. section 6110(b)(1). Section 521(b) of Pub. L. 106–170 provides that the Secretary of the Treasury must prepare a report for public disclosure that includes certain specifically designated information concerning all APAs, including this APA, in a form that does not reveal taxpayers' identities, trade secrets, and proprietary or confidential business or financial information.

8. *Disputes*. If a dispute arises concerning the interpretation of this APA, the Parties will seek a resolution by the IRS Associate Chief Counsel (International), to the extent reasonably practicable, before seeking alternative remedies. If any dispute arises that is not related to interpreting this APA, the Parties will seek to resolve the dispute in a manner consistent with Revenue Procedure 96–53, section 11.03(4).

9. *Materiality*. In this APA the terms "material" and "materially" will be interpreted consistently with the definition of "material facts" in Revenue Procedure 96–53, section 11.05(1).

10. *Section Captions*. This APA's section captions, which appear in *italics*, are for convenience and reference only. The captions do not affect in any way the interpretation or application of this APA.

11. *Entire Agreement and Severability*. This APA is the complete statement of the Parties' agreement. The Parties will sever, delete, or reform any invalid or unenforceable provision in this APA to approximate the Parties' intent as nearly as possible.

12. *Successor in Interest*. This contract binds, and inures to the benefit of, any successor in interest to Taxpayer.

13. *Notice*. Any notices required by this APA or Revenue Procedure 96–53 must be in writing. Taxpayer will send notices to the IRS at the address and in the manner set forth in Revenue Procedure 96–53, section 5.13(2). The IRS will send notices to:

Taxpayer Corporation
1000 Road
Any City, USA 10000
Attn: Jane Doe,
Sr. Vice President (Taxes)

14. *Effective date and Counterparts*. This APA is effective starting on the date, or later date of the dates, upon which all Parties execute this APA. The Parties may execute this APA in counterparts, with each counterpart constituting an original.

WITNESS,

The Parties have executed this APA on the dates below.

[Taxpayer Name in all caps]

By: ________________________________ Date: __________, 20 _____

Jane Doe
Sr. Vice President (Taxes)

IRS

By: ________________________________ Date: __________, 20 _____

Sean F. Foley
Director, Advance Pricing Agreement Program

APPENDIX A

COVERED TRANSACTIONS AND TRANSFER PRICING METHOD (TPM)

1. **Covered Transactions**.

[*Define the Covered Transactions.*]

2. **TPM**.

{Note: If appropriate, adapt language from the following examples.}

- **CUP Method**

The TPM is the comparable uncontrolled price (CUP) method. The price charged for ____________ must equal between __________ and ______________ (the Arm's Length Range). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect such pricing.

- **Resale Price Method (RPM)**

The TPM is the resale price method (RPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross margin (defined as gross profit divided by sales revenue as those terms are defined in Treasury Regulations sections 1.482–5(d)(1) and (2)) of between _____% and _____% (the Arm's Length Range) for the Covered Transactions.

- **Cost Plus Method**

The TPM is the cost plus method. Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a ratio of gross profit to production costs (within the meaning of Treasury Regulations sections 1.482–3(d)(1) and (2)) of between _____% and _____% (the Arm's Length Range) for the Covered Transactions.

- **CPM with Berry Ratio PLI**

The TPM is the comparable profits method (CPM). Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect a gross profit to operating expenses ratio (as those terms are defined in Treasury Regulations sections 1.482–5(d)(1) and (2)) of between _______ and _____ (the Arm's Length Range) for the Covered Transactions.

- **CPM using an Operating Margin PLI**

The TPM is the comparable profits method (CPM). The profit level indicator is an operating margin. Taxpayer's reported operating profit (within the meaning of Treasury Regulations sections 1.482–5(d)(5)) must clearly reflect an operating margin (defined as the ratio of operating profit to sales revenue as those terms are defined in Treasury Regulations section 1.482–5(d)(1) and (4)) of between __________% and _______% (the Arm's Length Range) for the Covered Transactions.

- **CPM using a Three-year Rolling Average Operating Margin PLI**

The TPM is the comparable profits method (CPM). The profit level indicator is an operating margin. Taxpayer's Three-Year Rolling Average operating margin is defined as follows for any APA Year: the sum of Taxpayer's reported operating profit (within the meaning of Treasury Regulations section 1.482–5(d)(5)) for that APA Year and the two preceding years, divided by the sum of Taxpayer's sales revenue (within the meaning of Treasury Regulations section 1.482–5(d)(1)) for that APA Year and the two preceding years. Taxpayer's Three-Year Rolling Average operating margin must be between _______% and _____ (the Arm's Length Range).

- **Residual Profit Split Method**

The TPM is the residual profit split method. Taxpayer must realize, recognize, and report results on its U.S. Returns that clearly reflect the following: [*insert description of profit-split mechanism*].

[*Insert additional provisions as needed.*]

3. **Adjustments**

{For use with a CPM}

For each APA Year, if Taxpayer's year-end [Three-Year Rolling Average] *{specify PLI used}* for the Covered Transactions is not in compliance with the TPM, Taxpayer will make an adjustment that brings its [Three-Year Rolling Average] *{specify PLI used}* to *{if the TPM specifies a point value, use that; if the TPM specifies an Arm's Length Range, use the nearest edge of the Arm's Length Range or a point such as the median within the Arm's Length Range}*.

[*Insert additional provisions as needed.*]

APPENDIX B

CRITICAL ASSUMPTIONS

This APA's critical assumptions are:

1. The business activities, functions performed, risks assumed, assets employed, and financial and tax accounting methods and classifications [and methods of estimation] of Taxpayer in relation to the Covered Transactions will remain materially the same as described or used in Taxpayer's APA Request. A mere change in business results will not be a material change.

[*Insert additional provisions as needed.*]

APPENDIX C

APA RECORDS AND ANNUAL REPORT

APA RECORDS

The APA Records will consist of:

1. All documents listed below for inclusion in the Annual Report, as well as all documents, notes, work papers, records, or other writings that support the information provided in such documents.

2. [Insert here other records as required.]

ANNUAL REPORT

Taxpayer must include the following items in its Annual Report for each APA Year:

1. Statements that fully identify, describe, analyze, and explain:

a. All material differences between any of Taxpayer's business operations (including functions, risks, markets, contractual terms, economic conditions, property or services, and assets employed) during the APA Year and the description of the business operations contained in the APA Request. If there have been no material differences, the Annual Report will include a statement to that effect.

b. All material changes in Taxpayer's accounting methods and classifications, and methods of estimation, from those described or used in Taxpayer's request for this APA. If there have been no such material changes, the Annual Report will include a statement to that effect.

c. Any failure to meet any critical assumption. If there have been no failures, the Annual Report will include a statement to that effect.

d. Any change to any entity classification for federal income tax purposes of any Worldwide Group member that is a party to the Covered Transactions or otherwise relevant to the TPM.

e. Any changes to Taxpayer's financial accounting methods that were made to conform to GAAP changes and that affect the Covered Transactions.

f. The amount, reason for, and financial analysis of any compensating adjustments under paragraph 5(e)(2) of this APA for the APA Year, including the means by which any such compensating adjustment has been or will be satisfied.

g. The amounts, description, reason for, and financial analysis of any book-tax differences relevant to the TPM for the APA Year, as reflected on Schedule M–1 of the U.S. Return for the APA Year.

2. The Financial Statements with a copy of each independent certified public accountant's opinion required by paragraph 5(c) of this APA.

3. A financial analysis that reflects Taxpayer's TPM calculations for the APA Year in sufficient detail to allow the IRS to determine whether Taxpayer has complied with the TPM.

4. An organizational chart for the Worldwide Group, revised annually to reflect all ownership or structural changes of entities that are parties to the Covered Transactions or otherwise relevant to the TPM.

APPENDIX D

DEFINITIONS

The following definitions control for all purposes of this APA. The definitions appear alphabetically below:

Term	Definition
Annual Report	A report within the meaning of Revenue Procedure 96–53, section 11.
APA	This Advance Pricing Agreement, which is an "advance pricing agreement" within the meaning of Revenue Procedure 96–53, section 1.
APA Records	The records specified in Appendix C.
APA Request	Taxpayer's request for this APA dated __/__/__, including any amendments or supplemental or additional information thereto.
Covered Transaction	This term is defined in Appendix A.
Financial Statements	The financial statements prepared in accordance with U.S. GAAP and stated in U.S. dollars.
Foreign Group	Worldwide Group members that are not U.S. persons.
Foreign Participants	[Name the foreign entities involved in Covered Transactions.]
I.R.C.	The Internal Revenue Code of 1986, 26 U.S.C., as amended.
Pub. L. 106–170	The Ticket to Work and Work Incentives Improvement Act of 1999.
Revenue Procedure 96–53	Rev. Proc. 96–53 (1996–2 C.B. 375).
Transfer Pricing Method (TPM)	A transfer pricing method within the meaning of Treasury Regulations section 1.482–1(b) and Revenue Procedure 96–53, section 3.02.
U.S. GAAP	U.S. generally-accepted accounting principles.
U.S. Group	Worldwide Group members that are U.S. persons.
U.S. Return	For each taxable year, the "returns with respect to income taxes under subtitle A" that Taxpayer must "make" in accordance with I.R.C. section 6012. *{Or substitute for partnership:* For each taxable year, the "return" that Taxpayer must "make" in accordance with I.R.C. section 6031.}
Worldwide Group	Taxpayer and all organizations, trades, businesses, entities, or branches (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests.

ATTACHMENT B

FORMULAS FOR BALANCE SHEET ADJUSTMENTS

Definitions of Variables:

AP	=	average accounts payable
AR	=	average trade accounts receivable, net of allowance for bad debt
cogs	=	cost of goods sold
INV	=	average inventory, stated on FIFO basis
opex	=	operating expenses (general, sales, administrative, and depreciation expenses)
PPE	=	property, plant, and equipment, net of accumulated depreciation
sales	=	net sales
tc	=	total cost (cogs + opex, as defined above)
h	=	average accounts payable or trade accounts receivable holding period, stated as a fraction of a year
i	=	interest rate
t	=	entity being tested
c	=	comparable

Equations:

If Cost of Goods Sold is controlled (generally, sales in denominator of PLI):

Receivables Adjustment ("RA"):	$RA = \{[AR_t / sales_t) \times sales_c] - AR_c\} \times \{i/[1+(i \times h_c)]\}$
Payables Adjustment ("PA"):	$PA = \{[AP_t / sales_t) \times sales_c] - AP_c\} \times \{i/[1+(i \times h_c)]\}$
Inventory Adjustment ("IA"):	$IA = \{[(INV_t / sales_t) \times sales_c\} - INV_c\} \times i$
PP&E Adjustment ("PPEA"):	$PPEA = \{[(PPE_t / sales_t) \times sales_c] - PPE_c\} \times i$

If Sales are controlled (generally, costs in the denominator of PLI):[16]

Receivables Adjustment ("RA"):	$RA = \{[(AR_t / tc_t) \times tc_c] - AR_c\} \times \{i/[1+(i \times h_c)]\}$
Payables Adjustment ("PA"):	$PA = \{[(AP_t / tc_t) \times tc_c] - AP_c\} \times \{i/[1+(i \times h_c)]\}$
Inventory Adjustment ("IA"):	$IA = \{[(INV_t / tc_t) \times tc_c] - INV_c\} \times i$
PP&E Adjustment ("PPEA"):	$PPEA = \{[(PPE_t / tc_t) \times tc_c] - PPE_c] \times i$

Then Adjust Comparables as Follows:

adjusted $sales_c$	=	$sales_c + RA$
adjusted $cogs_c$	=	$cogs_c + PA - IA$
adjusted $opex_c$	=	$opex_c - PPEA$

[16] Depending on the specific facts, the equations below may use total costs ("tc") or cost of goods sold ("cogs").

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
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T—Target Corporation.
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T.I.R.—Technical Information Release.
TP—Taxpayer.
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TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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2002-16

Internal Revenue
bulletin

Bulletin No. 2002–16
April 22, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–18, page 779.
LIFO; price indexes; department stores. The February 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, February 28, 2002.

Rev. Rul. 2002–19, page 778.
Medical expenses. Uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician are expenses for medical care under section 213 of the Code. The cost of purchasing diet food items is not deductible under section 213. Rev. Ruls. 55–261 and 79–151 distinguished.

T.D. 8986, page 780.
Final regulations under section 705 of the Code provide guidance for making basis adjustments necessary to coordinate sections 705 and 1032 in situations in which a corporation acquires an interest in a partnership that holds stock in that corporation.

REG–165706–01, page 787.
Proposed regulations modify the definition of a refunding issue under section 1.150–1(d) of the regulations in connection with a combination of section 501(c)(3) organizations. Generally, interest on bonds issued by state and local governments is excluded from gross income, however, this exclusion does not apply to certain refunding issues. A public hearing is scheduled for July 30, 2002.

REG–167648–01, page 790.
Proposed regulations under section 705 of the Code provide guidance for making basis adjustments necessary to coordinate sections 705 and 1032 in situations in which a corporation owns a direct or indirect interest in a partnership that holds stock in that corporation.

Announcement 2002–43, page 792.
This announcement describes a closing agreement program relating to certain state or local bonds issued in connection with affiliations of section 501(c)(3) hospital organizations.

EMPLOYEE PLANS

Notice 2002–24, page 785.
Section 6039D returns with respect to certain fringe benefits. This notice suspends the filing requirement imposed on specified fringe benefit plans by section 6039D of the Code. Notice 90–24 modified and superseded.

Notice 2002–28, page 785.
Weighted average interest rate update. The weighted average interest rate for April 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

REG–165706–01, page 787.
Proposed regulations modify the definition of a refunding issue under section 1.150–1(d) of the regulations in connection with a combination of section 501(c)(3) organizations. Generally, interest on bonds issued by state and local governments is excluded from gross income, however, this exclusion does not apply to certain refunding issues. A public hearing is scheduled for July 30, 2002.

Announcement 2002–43, page 792.
This announcement describes a closing agreement program relating to certain state or local bonds issued in connection with affiliations of section 501(c)(3) hospital organizations.

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The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Section 103.—Interest on State and Local Bonds

The Service announces a closing agreement program relating to certain state or local bonds issued in connection with affiliations of 501(c)(3) hospital organizations. See Ann. 2002–43, page 792.

Section 149(d).—Advance Refundings

The Service announces a closing agreement program relating to certain state or local bonds issued in connection with affiliations of 501(c)(3) hospital organizations. See Ann. 2002–43, page 792.

Section 150.—Definitions and Special Rules

26 CFR 1.150–1(d): Definition of refunding issue and related definitions.

The Service announces a closing agreement program relating to certain state or local bonds issued in connection with affiliations of 501(c)(3) hospital organizations. See Ann. 2002–43, page 792.

Section 213.—Medical, Dental, etc., Expenses

26 CFR 1.213–1: Medical, Dental, etc., Expenses. (Also § 262; 1.262–1.)

Medical expenses. Uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician are expenses for medical care under section 213 of the Code. The cost of purchasing diet food items is not deductible under section 213 of the Code.

Rev. Rul. 2002–19

ISSUE

Are uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or ailment (including obesity) diagnosed by a physician and for diet food items expenses for medical care that are deductible under § 213 of the Internal Revenue Code?

FACTS

Taxpayer *A* is diagnosed by a physician as obese. *A* does not suffer from any other specific disease. Taxpayer *B* is not obese but suffers from hypertension. *B* has been directed by a physician to lose weight as treatment for the hypertension.

A and *B* participate in the *X* weight-loss program. *A* and *B* are required to pay an initial fee to join *X* and an additional fee to attend periodic meetings. At the meetings participants develop a diet plan, receive diet menus and literature, and discuss problems encountered in dieting. *A* and *B* also purchase *X* brand reduced-calorie diet food items. Neither *A*'s nor *B*'s costs are compensated by insurance or otherwise.

LAW

Section 213(a) allows a deduction for uncompensated expenses for medical care of an individual, the individual's spouse or a dependent, to the extent the expenses exceed 7.5 percent of adjusted gross income. Section 213(d)(1) provides, in part, that medical care means amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

Under § 1.213–1(e)(1)(ii) of the Income Tax Regulations, the deduction for medical care expenses will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. An expense that is merely beneficial to the general health of an individual is not an expense for medical care. Whether an expenditure is primarily for medical care or is merely beneficial to general health is a question of fact.

Section 262 provides that, except as otherwise expressly provided by the Code, no deduction is allowed for personal, living, or family expenses.

Rev. Rul. 79–151 (1979–1 C.B. 116) holds that a taxpayer who participates in a weight reduction program to improve the taxpayer's appearance, general health, and sense of well-being, and not to cure a specific ailment or disease, may not deduct the cost as a medical expense under § 213.

Rev. Rul. 55–261 (1955–1 C.B. 307) holds that medical care includes the cost of special food if (1) the food alleviates or treats an illness, (2) it is not part of the normal nutritional needs of the taxpayer, and (3) the need for the food is substantiated by a physician. However, special food that is a substitute for the food the taxpayer normally consumes and that satisfies the taxpayer's nutritional needs is not medical care.

ANALYSIS

Amounts paid for the primary purpose of treating a disease are deductible as medical care. Obesity is medically accepted to be a disease in its own right. The National Heart, Lung, and Blood Institute, part of the National Institutes of Health, describes obesity as a "complex, multifactorial chronic disease." *Clinical Guidelines on the Identification, Evaluation, and Treatment of Overweight and Obesity in Adults* (1998), page vii. This report is based on an evaluation by a panel of health professionals of scientific evidence published from 1980 to 1997.

Other government and scientific entities have reached similar conclusions. For example, in a preamble to final regulations the Food and Drug Administration states "obesity is a disease." 65 Fed. Reg. 1027, 1028 (Jan. 6, 2000). The World Health Organization states that "[o]besity is now well recognized as a disease in its own right ...." Press Release 46 (June 12, 1997).

In the present case, a physician has diagnosed *A* as suffering from a disease, obesity. Therefore, the cost of *A*'s participation in the *X* weight-loss program as treatment for *A*'s obesity is an amount paid for medical care under § 213(d)(1). Although *B* is not suffering from obesity, *B*'s participation in *X* is part of the treatment for *B*'s hypertension. Therefore, *B*'s cost of participating in the program is also an amount paid for medical care. *A* and *B* may deduct under § 213 (subject to the limitations of that section) the fees to

join the program and to attend periodic meetings. These situations are distinguishable from the facts of Rev. Rul. 79–151, in which the taxpayer was not suffering from any specific disease or ailment and participated in a weight-loss program merely to improve the taxpayer's general health and appearance. However, *A* and *B* may not deduct any portion of the cost of purchasing reduced-calorie diet foods because the foods are substitutes for the food *A* and *B* normally consume and satisfy their nutritional requirements.

HOLDING

Uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician are expenses for medical care that are deductible under § 213, subject to the limitations of that section. The cost of purchasing diet food items is not deductible under § 213.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 79–151 and Rev. Rul. 55–261 are distinguished.

CONTACT INFORMATION

For further information regarding this revenue ruling, contact John T. Sapienza, Jr., at (202) 622–7900 (not a toll-free call).

Section 262.—Personal, Living, and Family Expenses

Are uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician expenses for medical care under § 213. See Rev. Rul. 2002–19 on page 778.

Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The February 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, February 28, 2002.

Rev. Rul. 2002–18

The following Department Store Inventory Price Indexes for February 2002 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46 (1986–2 C.B. 739), for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, February 28, 2002.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

	Groups	Feb. 2001	Feb. 2002	Percent Change from Feb. 2001 to Feb. 2002[1]
1.	Piece Goods	507.2	485.6	-4.3
2.	Domestics and Draperies	606.8	580.1	-4.4
3.	Women's and Children's Shoes	642.9	621.0	-3.4
4.	Men's Shoes	881.9	877.6	-0.5
5.	Infants' Wear	620.5	609.4	-1.8
6.	Women's Underwear	563.4	571.0	1.3
7.	Women's Hosiery	351.5	351.1	-0.1
8.	Women's and Girls' Accessories	550.1	563.0	2.3
9.	Women's Outerwear and Girls' Wear	388.0	375.0	-3.4
10.	Men's Clothing	594.4	579.7	-2.5
11.	Men's Furnishings	608.1	586.7	-3.5
12.	Boys' Clothing and Furnishings	484.7	473.6	-2.3
13.	Jewelry	943.6	889.5	-5.7
14.	Notions	794.5	775.7	-2.4
15.	Toilet Articles and Drugs	986.1	975.9	-1.0
16.	Furniture and Bedding	685.9	626.0	-8.7
17.	Floor Coverings	630.2	618.8	-1.8

[1] Absence of a minus sign before the percentage change in this column signifies a price increase.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS—CONTINUED
(January 1941 = 100, unless otherwise noted)

Groups	Feb. 2001	Feb. 2002	Percent Change from Feb. 2001 to Feb. 2002[1]
18. Housewares	774.9	757.3	-2.3
19. Major Appliances	227.8	224.5	-1.4
20. Radio and Television	56.3	51.7	-8.2
21. Recreation and Education[2]	90.7	87.9	-3.1
22. Home Improvements[2]	128.0	125.6	-1.9
23. Auto Accessories[2]	108.8	110.3	1.4
Groups 1 — 15: Soft Goods	592.0	575.3	-2.8
Groups 16 — 20: Durable Goods	433.1	415.5	-4.1
Groups 21 — 23: Misc. Goods[2]	99.2	97.4	-1.8
Store Total[3]	532.4	516.6	-3.0

1 Absence of a minus sign before the percentage change in this column signifies a price increase.
2 Indexes on a January 1986=100 base.
3 The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7718 (not a toll-free call).

Section 705.—Determination of Basis of Partner's Interest

26 CFR 1.705–1: Determination of basis of partner's interest.

T.D. 8986

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Determination of Basis of Partner's Interest; Special Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations

SUMMARY: This document contains final regulations relating to special rules on determination of basis of a partner's interest under section 705 of the Internal Revenue Code. The final regulations are necessary to coordinate sections 705 and 1032.

DATES: *Effective Date*: These regulations are effective on March 29, 2002.

Applicability Date: These regulations are applicable with respect to sales or exchanges of stock occurring after December 6, 1999.

FOR FURTHER INFORMATION CONTACT: Barbara MacMillan or Rebekah A. Myers (202) 622–3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

In Rev. Rul. 99–57 (1999–2 C.B. 678), the IRS issued guidance with respect to the tax consequences for a partnership and a corporate partner where the corporate partner contributes its own stock to the partnership, and the partnership later exchanges the stock with a third party in a taxable transaction. Under that ruling, section 1032 will protect a corporate partner from recognizing gain or loss (to the extent allocated to such partner) when the partnership exchanges stock of the corporate partner in a taxable transaction. The ruling also concludes that, under section 705, the corporate partner increases its basis in its partnership interest by an amount equal to its share of the gain resulting from the partnership's sale or exchange of the stock.

In situations where a corporation acquires an interest in a partnership that holds that corporation's stock, a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquires the partnership interest, and the partnership later sells or exchanges the stock, it may be inconsistent with the intent of sections 705 and 1032 to increase the basis of the corporation's partnership interest by the full amount of the gain that is not recognized.

For instance, assume that a corporation (A) purchases a 50 percent interest in a partnership for $100,000. The partnership's only asset is A stock with a basis of $100,000 and a value of $200,000. If the

partnership had not made a section 754 election, then when the partnership disposes of the property for $200,000, A would be allocated $50,000 of gain. Under section 1032, the gain allocated to A would not be subject to tax. If A's basis in the partnership interest were increased to $150,000 under section 705(a)(1), A would recognize a corresponding $50,000 loss (or reduced gain) upon a subsequent sale of the partnership interest. In this situation, it would be inconsistent with the intent of sections 705 and 1032 to increase the basis of A's partnership interest for the gain that is not recognized. To do so would create a recognizable loss (or reduced gain) in a situation where no economic loss was incurred and no offsetting gain had previously been recognized.

Accordingly, in Notice 99–57 (1999–2 C.B. 692), the IRS announced that it intended to promulgate regulations under section 705 to address certain situations where a corporation acquires an interest in a partnership that holds stock in that corporation, and a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquired the interest. The IRS announced that rules regarding tiered-entity structures also would be included in the regulations. The IRS requested comments as to the appropriate scope of the regulations regarding other situations where the price paid for a partnership interest reflects built-in gain or accrued income items that will not be subject to tax, or built-in loss or accrued deductions that will be permanently denied, when allocated to the transferee partner, and the partnership has not made an election under section 754. No formal comments were received.

On January 3, 2001, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–106702–00, 2001–4 I.R.B. 424) under section 705 of the Internal Revenue Code (Code) in the **Federal Register** (66 FR 315). Only one commentator submitted written comments in response to the notice of proposed rulemaking, and no public hearing was requested or held. After consideration of the comment, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Contents

1. Overview of Provisions

As discussed in Notice 99–57, these final regulations are being issued in order to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock.

The final regulations set forth a detailed statement of the purpose for these regulations which is consistent with the discussion in Notice 99–57. The final regulations then provide a specific rule implementing this purpose in situations where a corporate partner holds a direct interest in a partnership that owns stock of the corporate partner. This rule applies where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the taxable year in which the corporation acquired the interest, a section 754 election had been in effect.

The purpose of these final regulations cannot be avoided through the use of tiered partnerships or other arrangements. For example, the final regulations provide that if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of the final regulations. As stated above, the final regulations include a statement describing the purpose of these regulations which is intended to guide taxpayers in making basis adjustments in the tiered partnership context. In addition, the final regulations include two examples illustrating the basis adjustments that are required by the final regulations where a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships.

2. The Secretary's Authority

The only comment received in response to the notice of proposed rulemaking discussed the Secretary's authority under section 705 to issue the regulations as proposed. Specifically, the comment suggested that the regulations could be challenged as inconsistent with the plain language of section 705. The comment acknowledged that the proposed regulations are a reasonable interpretation of section 705, but argued that the aggregate treatment of partnerships in the context of section 1032 provides a stronger basis for the Secretary's authority.

Accordingly, the final regulations clarify that the authority for the regulations includes both sections 705 and 1032. As explained in Rev. Rul. 99–57, the use of the aggregate theory of partnerships in the context of section 1032 is necessary to carry out the intent of that section. To reflect this application of the aggregate theory of partnerships and prevent any unintended benefit or detriment to the partners, appropriate adjustments under section 705 must be made to a corporate partner's outside basis. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 225 (1954); S. Rep. No. 1337, 83d Cong. 2d Sess. 384 (1954). Thus, the regulations provide the mechanical rules necessary to implement Congressional intent under both sections 705 and 1032.

3. Technical Correction Relating to Tiered Partnerships

The comment suggested technical changes to the proposed regulations to prevent taxpayers in tiered partnership situations from inappropriately allocating to the corporate partner a loss resulting from a sale of a lower-tier partnership (LTP) interest that is attributable to gain

allocated to and recognized by the noncorporate partners upon the LTP's sale of the corporate partner's stock. The final regulations include modifications to prevent such inappropriate allocations.

4. De Minimis Rule

The comment suggested that an elective *de minimis* rule would be appropriate as a matter of administrative convenience. However, after considering the purpose of these regulations and issues of administrative burden and technical complexity, Treasury and the IRS have determined that a *de minimis* rule is unnecessary.

5. Scope of the Regulations

The comment suggested that the regulations provide guidance with respect to the issues addressed in Rev. Rul. 96–10 (1996–1 C.B. 138) (partners' bases in their partnership interests are increased to reflect gain from the sale of partnership property that is not recognized under sections 267(d) and 707(b)(1)) and Rev. Rul. 96–11 (1996–1 C.B. 140) (a charitable contribution of property by a partnership reduces each partner's basis in the partnership by the partner's share of the partnership's basis in the property contributed). Treasury and the IRS believe that these issues are beyond the scope of these regulations. Accordingly, this comment is not addressed in these regulations.

6. Other Developments

The notice of proposed rulemaking (REG–167648–01) issued elsewhere in this issue of the Bulletin addresses remaining issues that Treasury and the IRS considered during the development of the final regulations. Specifically, the proposed regulations apply principles similar to those applied in the final regulations where a corporation's indirect interest in its own stock held through one or more partnerships increases as the result of a distribution of partnership property to another partner and the partnership does not have a section 754 election in effect at the time of the distribution. In addition, the proposed regulations clarify that references in the regulations to stock of a corporate partner include any position in stock of a corporate partner to which section 1032 applies. Certain minor, nonsubstantive changes were made to the final regulations to accommodate the eventual incorporation of the proposed regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Drafting Information

The principal author of these regulations is Barbara MacMillan of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding a citation to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.705–2 also issued under 26 U.S.C. 705 and 1032.

* * *

Par. 2. Section 1.705–1 is amended by adding paragraph (a)(7) to read as follows:

§ 1.705–1 Determination of basis of partner's interest.

(a) * * *

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock of a corporation that holds a direct or indirect interest in the partnership, see § 1.705–2.

* * * * *

Par. 3. Section 1.705–2 is added to read as follows:

§ 1.705–2 Basis adjustments coordinating sections 705 and 1032.

(a) *Purpose.* This section coordinates the application of sections 705 and 1032 and is intended to prevent inappropriate increases or decreases in the adjusted basis of a corporate partner's interest in a partnership resulting from the partnership's disposition of the corporate partner's stock. The rules under section 705 generally are intended to preserve equality between the adjusted basis of a partner's interest in a partnership (outside basis) and such partner's share of the adjusted basis in partnership assets (inside basis). However, in situations where a section 754 election was not in effect for the year in which a partner acquired its interest, the partner's inside basis and outside basis may not be equal. In these situations, gain or loss allocated to the partner upon disposition of the partnership assets that is attributable to the difference between the adjusted basis of the partnership assets absent the section 754 election and the adjusted basis of the partnership assets had a section 754 election been in effect generally will result in an adjustment to the basis of the partner's interest in the partnership under section 705(a). Such gain (or loss), therefore, generally will be offset by a corresponding decrease in the gain or increase in the loss (or increase in the gain or decrease in the loss) upon the subsequent disposition by the partner of its interest in the partnership. Where such a difference exists with respect to stock of a corporate partner that is held by the partnership, gain or loss from the disposition of corporate partner stock attributable to the difference is not recognized by the corporate partner under section 1032. To adjust the basis of the corporate partner's interest in the partnership for this unrecognized gain or loss would not be appropriate because

it would create an opportunity for the recognition of taxable gain or loss on a subsequent disposition of the partnership interest where no economic gain or loss has been incurred by the corporate partner and no corresponding taxable gain or loss had previously been allocated to the corporate partner by the partnership.

(b) *Single partnership*—(1) *Required adjustments relating to acquisitions of partnership interest*. (i) This paragraph (b)(1) applies in situations where a corporation acquires an interest in a partnership that holds stock in that corporation (or the partnership subsequently acquires stock in that corporation in an exchanged basis transaction), the partnership does not have an election under section 754 in effect for the year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the corporation acquired the interest, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(1) are illustrated by the following example:

Example. (i) A, B, and C form equal partnership PRS. Each partner contributes $30,000 in exchange for its partnership interest. PRS has no liabilities. PRS purchases stock in corporation X for $30,000, which appreciates in value to $120,000. PRS also purchases inventory for $60,000, which appreciates in value to $150,000. A sells its interest in PRS to corporation X for $90,000 in a year for which an election under section 754 is not in effect. PRS later sells the X stock for $150,000. PRS realizes a gain of $120,000 on the sale of the X stock. X's share of the gain is $40,000. Under section 1032, X does not recognize its share of the gain.

(ii) Normally, X would be entitled to a $40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the X stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which X acquired its interest in PRS, X would have been entitled to a basis adjustment under section 743(b) of $60,000 (the excess of X's basis for the transferred partnership interest over X's share of the adjusted basis to PRS of PRS's property). See § 1.743–1(b). Under § 1.755–1(b), the basis adjustment under section 743(b) would have been allocated $30,000 to the X stock (the amount of the gain that would have been allocated to X from the hypothetical sale of the stock), and $30,000 to the inventory (the amount of the gain that would have been allocated to X from the hypothetical sale of the inventory).

(iii) If a section 754 election had been in effect for the year in which X acquired its interest in PRS, the amount of gain that X would have recognized upon PRS's disposition of X stock (absent the application of section 1032) would be $10,000 (X's share of PRS's gain from the stock sale, $40,000, minus the amount of X's basis adjustment under section 743(b), $30,000). See § 1.743–1(j). Accordingly, the increase in the basis of X's interest in PRS is $10,000.

(2) [Reserved]

(c) *Tiered partnerships and other arrangements*—(1) *Required adjustments*. The purpose of these regulations as set forth in paragraph (a) of this section cannot be avoided through the use of tiered partnerships or other arrangements. For example, if a corporation acquires an indirect interest in its own stock through a chain of two or more partnerships (either where the corporation acquires a direct interest in a partnership or where one of the partnerships in the chain acquires an interest in another partnership), and gain or loss from the sale or exchange of the stock is subsequently allocated to the corporation, then the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

(2) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. Acquisition of upper-tier partnership interest by corporation. (i) A, B, and C form a partnership (UTP), with each partner contributing $25,000. UTP and D form a partnership (LTP). UTP contributes $75,000 in exchange for its interest in LTP, and D contributes $25,000 in exchange for D's interest in LTP. Neither UTP nor LTP has any liabilities. LTP purchases stock in corporation E for $100,000, which appreciates in value to $1,000,000. C sells its interest in UTP to corporation E for $250,000 in a year for which an election under section 754 is not in effect for UTP or LTP. LTP later sells the E stock for $2,000,000. LTP realizes a $1,900,000 gain on the sale of the E stock. UTP's share of the gain is $1,425,000, and E's share of the gain is $475,000. Under section 1032, E does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the E stock (including E's share) were to increase the basis of UTP's interest in LTP, UTP's basis in such interest would be $1,500,000 ($75,000 + $1,425,000). The fair market value of UTP's interest in LTP is $1,500,000. Because UTP did not have a section 754 election in effect for the taxable year in which E acquired its interest in UTP, UTP's basis in the LTP interest does not reflect the purchase price paid by E for its interest. Increasing the basis of UTP's interest in LTP by the full amount of the gain that would be recognized (in the absence of section 1032) on the sale of the E stock preserves the conformity between UTP's inside basis and outside basis with respect to LTP (*i.e.*, UTP's share of LTP's cash is equal to $1,500,000, and UTP's basis in the LTP interest is $1,500,000) and appropriately would cause UTP to recognize no gain or loss on the sale of UTP's interest in LTP immediately after the sale of the E stock. Accordingly, increasing the basis of UTP's interest in LTP by the entire amount of gain allocated to UTP (including E's share) from LTP's sale of the E stock is consistent with the purpose of this section. The $1,425,000 of gain allocated by LTP to UTP will increase the adjusted basis of UTP's interest in LTP under section 705(a)(1). The basis of UTP's interest in LTP immediately after the sale of the E stock is $1,500,000.

(iii) With respect to the basis of E's interest in UTP, if E's share of the gain allocated to UTP and then to E were to increase the basis of E's interest in UTP, E's basis in such interest would be $725,000 ($250,000 + $475,000) and the fair market value of such interest would be $500,000, so that E would recognize a loss of $225,000 if E sold its interest in UTP immediately after LTP's disposition of the E stock. It would be inappropriate for E to recognize a taxable loss of $225,000 upon a disposition of its interest in UTP because E would not incur an economic loss in the transaction, and E did not recognize a taxable gain upon LTP's disposition of the E stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing E's basis in its UTP interest by the entire amount of gain allocated to E from the sale of the E stock is not consistent with the purpose of this section. (Conversely, because A and B were allocated taxable gain on the disposition of the E stock, it would be appropriate to increase A's and B's bases in their respective interests in UTP by the full amount of the gain allocated to them.)

(iv) The appropriate basis adjustment for E's interest in UTP upon the disposition of the E stock by LTP can be determined as the amount of gain that E would have recognized (in the absence of section 1032) upon the sale by LTP of the E stock if both UTP and LTP had made section 754 elections for the taxable year in which E acquired the interest in UTP. If section 754 elections had been in effect for UTP and LTP for the year in which E acquired E's interest in UTP, the following would occur. E would be entitled to a $225,000 positive basis adjustment under section 743(b) with respect to the property of UTP. The entire basis adjustment would be allocated to UTP's only asset, its interest in LTP. In addition, the sale of C's interest in UTP would be treated as a deemed sale of E's share of UTP's interest in LTP for purposes of sections 754 and 743. The deemed selling price of E's share of UTP's interest in LTP would be $250,000 (E's share of UTP's adjusted basis in LTP, $25,000, plus E's basis adjustment under section 743(b) with respect to the assets of UTP, $225,000). The deemed sale of E's share of UTP's interest in LTP would trigger a basis adjustment under section 743(b) of $225,000 with respect to the assets of LTP (the excess of E's share of UTP's adjusted basis in LTP, including E's basis adjustment ($225,000), $250,000, over E's share of the adjusted basis of LTP's property, $25,000). This $225,000 adjustment by LTP would be allocated to

LTP's only asset, the E stock, and would be segregated and allocated solely to E. The amount of LTP's gain from the sale of the E stock (before considering section 743(b)) would be $1,900,000. E's share of this gain, $475,000, would be offset in part by the $225,000 basis adjustment under section 743(b), so that E would recognize gain equal to $250,000 in the absence of section 1032.

(v) If the basis of E's interest in UTP were increased by $250,000, the total basis of E's interest would equal $500,000. This would conform to E's share of UTP's basis in the LTP interest ($1,500,000 x 1/3 = $500,000) as well as E's indirect share of the cash held by LTP ((1/3 x 3/4) x $2,000,000 = $500,000). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by E on a subsequent disposition of E's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the $475,000 gain allocated to E, only $250,000 will apply to increase the adjusted basis of E in UTP under section 705(a)(1). E's adjusted basis in its UTP interest following the sale of the E stock is $500,000.

Example 2. Acquisition of lower-tier partnership interest by upper-tier partnership. (i) A, corporation B, and C form an equal partnership (UTP), with each partner contributing $100,000. D, E, and F also form an equal partnership (LTP), with each partner contributing $30,000. LTP purchases stock in corporation B for $90,000, which appreciates in value to $900,000. LTP has no liabilities. UTP purchases D's interest in LTP for $300,000. LTP does not have an election under section 754 in effect for the taxable year of UTP's purchase. LTP later sells the B stock for $900,000. UTP's share of the gain is $270,000, and B's share of that gain is $90,000. Under section 1032, B does not recognize its share of the gain.

(ii) With respect to the basis of UTP's interest in LTP, if all of the gain from the sale of the B stock (including B's share) were to increase the basis of UTP's interest in LTP, UTP's basis in the LTP interest would be $570,000 ($300,000 + $270,000), and the fair market value of such interest would be $300,000, so that B would be allocated a loss of $90,000 (($570,000 — $300,000) x 1/3) if UTP sold its interest in LTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of $90,000 upon a disposition of UTP's interest in LTP. B would not incur an economic loss in the transaction, and B was not allocated a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of UTP's interest in LTP. Accordingly, increasing UTP's basis in its LTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because E and F were allocated taxable gain on the disposition of the B stock, it would be appropriate to increase E's and F's bases in their respective interests in LTP by the full amount of such gain.)

(iii) The appropriate basis adjustment for UTP's interest in LTP upon the disposition of the B stock by LTP can be determined as the amount of gain that UTP would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that subsequently is allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a $90,000 positive basis adjustment under section 743(b), allocable to B, in the property of LTP. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be $810,000. UTP's share of this gain, $270,000, would be offset, in part, by the basis adjustment under section 743(b), so that UTP would recognize gain equal to $180,000.

(iv) If the basis of UTP's interest in LTP were increased by $180,000, the total basis of UTP's partnership interest would equal $480,000. This would conform to the sum of UTP's share of the cash held by LTP ((1/3 x $900,000 = $300,000) and the taxable gain recognized by A and C on the disposition of the B stock that appropriately may be offset on the disposition of their interests in UTP ($90,000 + $90,000 = $180,000). Such a basis adjustment does not inappropriately create the opportunity for the allocation of a loss to B on a subsequent disposition of UTP's interest in LTP and is consistent with the purpose of this section. Accordingly, of the $270,000 gain allocated to UTP, only $180,000 will apply to increase the adjusted basis of UTP in LTP under section 705(a)(1). Such $180,000 basis increase must be segregated and allocated $90,000 each to solely A and C. UTP's adjusted basis in its LTP interest following the sale of the B stock is $480,000.

(v) With respect to B's interest in UTP, if B's share of the gain allocated to UTP and then to B were to increase the basis of B's interest in UTP, B would have a UTP partnership interest with an adjusted basis of $190,000 ($100,000 + $90,000) and a value of $100,000, so that B would recognize a loss of $90,000 if B sold its interest in UTP immediately after LTP's disposition of the B stock. It would be inappropriate for B to recognize a taxable loss of $90,000 upon a disposition of its interest in UTP because B would not incur an economic loss in the transaction, and B did not recognize a taxable gain upon LTP's disposition of the B stock that appropriately would be offset by a taxable loss on the disposition of its interest in UTP. Accordingly, increasing B's basis in its UTP interest by the gain allocated to B from the sale of the B stock is not consistent with the purpose of this section. (Conversely, because A and C were allocated taxable gain on the disposition of the B stock that is a result of LTP not having a section 754 election in effect, it would be appropriate for A and C to recognize an offsetting taxable loss on the disposition of A's and C's interests in UTP. Accordingly, it would be appropriate to increase A's and C's bases in their respective interests in UTP by the amount of gain recognized by A and C.)

(vi) The appropriate basis adjustment for B's interest in UTP upon the disposition of the B stock by LTP can be determined as the amount of gain that B would have recognized (in the absence of section 1032) upon the sale by LTP of the B stock if the portion of the gain allocated to UTP that is subsequently allocated to B were determined as if LTP had made an election under section 754 for the taxable year in which UTP acquired its interest in LTP. If a section 754 election had been in effect for LTP for the year in which UTP acquired its interest in LTP, then with respect to B, the following would occur. UTP would be entitled to a basis adjustment under section 743(b) in the property of LTP of $90,000 with respect to B. The entire basis adjustment would be allocated to LTP's only asset, its B stock. The amount of LTP's gain from the sale of the B stock (before considering section 743(b)) would be $810,000. UTP's share of this gain, $270,000, would be offset, in part, by the $90,000 basis adjustment under section 743(b), so that UTP would recognize gain equal to $180,000. The $90,000 basis adjustment would completely offset the gain that otherwise would be allocated to B.

(vii) If no gain were allocated to B so that the basis of B's interest in UTP was not increased, the total basis of B's interest would equal $100,000. This would conform to B's share of UTP's basis in the LTP interest (($480,000 - $180,000 (*i.e.*, A's and C's share of the basis that should offset taxable gain recognized as a result of LTP's failure to have a section 754 election)) x 1/3 = $100,000) as well as B's indirect share of the cash held by LTP ((1/3 x 1/3) x $900,000 = $100,000). Such a basis adjustment does not create the opportunity for the recognition of an inappropriate loss by B on a subsequent disposition of B's interest in UTP and is consistent with the purpose of this section. Accordingly, under this paragraph (c), of the $90,000 gain allocated to B, none will apply to increase the adjusted basis of B in UTP under section 705(a)(1). B's adjusted basis in its UTP interest following the sale of the B stock is $100,000.

(viii) Immediately after LTP's disposition of the B stock, UTP sells its interest in LTP for $300,000. UTP's adjusted basis in its LTP interest is $480,000, $180,000 of which must be allocated $90,000 each to A and C. Accordingly, upon UTP's sale of its interest in LTP, UTP realizes $180,000 of loss, and A and C in turn each realize $90,000 of loss.

(d) [Reserved] (e) *Effective date.* This section applies to gain or loss allocated with respect to sales or exchanges of stock occurring after December 6, 1999.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved March 14, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on March 28, 2002, 8:45 a.m., and published in the issue of the Federal Register for March 29, 2002, 67 F.R. 15112)

Part III. Administrative, Procedural, and Miscellaneous

Section 6039D Reporting Requirements

Notice 2002–24

PURPOSE

This notice suspends the filing requirement imposed on specified fringe benefit plans by section 6039D of the Internal Revenue Code and modifies and supersedes Notice 90–24 (1990–1 C. B. 335).

BACKGROUND

Section 6039D of the Code, as enacted by Pub. L. 98–611, § 1, 98 Stat. 3176 (1984), required employers maintaining group legal services plans described in section 120, cafeteria plans described in section 125, and educational assistance programs described in section 127 to file an annual information return with the Internal Revenue Service. Announcement 86–20 (1986–7 I.R.B. 34) required the return for these plans to be filed on the Form 5500 Series Annual Return/Report. Section 1151(h) of the Tax Reform Act of 1986 (TRA '86), amended section 6039D and expanded the reporting requirement to group-term life insurance plans described in section 79, accident and health plans described in sections 105 and 106, and dependent care assistance programs described in section 129. Section 1601(h)(2)(D)(iii) of the Small Business Job Protection Act of 1996 added adoption assistance programs described in section 137 to the list of specified fringe benefit plans required to file annual returns under section 6039D.

Notice 90–24 suspended the filing requirement for those fringe benefit plans added to section 6039D by the TRA '86. The notice stated that, until the Service provides further guidance, employers maintaining plans under sections 79, 105, and 106, or 129, are not required to file information returns pursuant to section 6039D. However, the notice instructed employers maintaining plans under sections 120, 125, or 127 to continue to file the return for these plans on the Form 5500 Series Annual Return/Report. Current filing instructions provide that plans described in sections 125, 127, and 137 are considered fringe benefit plans and must file Schedule F attached to a completed Form 5500 to satisfy the annual return requirement of section 6039D. The IRS is evaluating whether this method of reporting the information required by section 6039D is appropriate.

RELIEF FROM FILING REQUIREMENTS AND EFFECTIVE DATE

Employers maintaining specified fringe benefit plans under sections 125, 127, or 137 are relieved from the requirement to file annual information returns (Schedule F) attached to a completed Form 5500 pursuant to section 6039D. This notice is effective upon publication and applies to all plan years for which information returns have not been filed. Any future reporting obligations under section 6039D will apply only to plan years beginning on or after the date of publication of further guidance.

This notice does not affect annual reporting requirements under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), or relieve administrators of employee benefit plans from any obligation to file a Form 5500 and any required schedules (other than the Schedule F) under that title. For further information on annual reporting requirements applicable to employee benefit plans under Title I of ERISA, see the instructions for the Form 5500 Annual Return/Report and the Department of Labor's Regulations. The Form 5500 instructions may be obtained by calling 1–800–TAX FORM, or may be viewed at *www.efast.dol.gov* or *www.irs.gov*.

DRAFTING INFORMATION

The principal author of this notice is Felix J. Zech of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, please contact Mr. Zech at (202) 622–6080 (not a toll-free number).

Weighted Average Interest Rate Update

Notice 2002–28

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73 (1988–2 C.B. 383) provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for March 2002 is 5.71 percent. Pursuant to Notice 2002–26, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 120% Permissible Range	90% to 110% Permissible Range
April	2002	5.69	5.12 to 6.83	5.12 to 6.26

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1–202–283–9888 (not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Obligations of States and Political Subdivisions

REG–165706–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations on the definition of refunding issue applicable to tax-exempt bonds issued by States and local governments. This document provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 9, 2002. Outlines of topics to be discussed at the public hearing scheduled for July 30, 2002, at 10 a.m., must be received by July 9, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–165706–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–165706–01), courier's desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, submissions may be made electronically to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Michael P. Brewer (202) 622–3980; concerning submissions and the hearing, Treena Garrett (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 150 of the Internal Revenue Code (Code) provides certain definitions and special rules for purposes of applying the tax-exempt bond limitations contained in sections 103 and 141 through 150. On June 18, 1993, final regulations (T.D. 8476, 1993–2 C.B. 13) under section 150 were published in the **Federal Register** (58 FR 33510). On May 9, 1997, additional final regulations (T.D. 8718, 1997–1 C.B. 47) under section 150 were published in the **Federal Register** (62 FR 25502). This document proposes to modify the definition of refunding issue under § 1.150–1(d).

Explanation of Provisions

Section 1.150–1(d) of the current regulations provides a definition of *refunding issue*. In general, a refunding issue is an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue. The current regulations contain certain exceptions to this general rule. One exception (the *change in obligor exception*) provides that an issue is not a refunding issue to the extent that the obligor of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue. Another exception (the *six-month exception*) provides that if a person assumes (including taking subject to) obligations of an unrelated party in connection with an asset acquisition (other than a transaction to which section 381(a) applies if the person assuming the obligation is the acquiring corporation within the meaning of section 381(a)), and the assumed issue is refinanced within six months before or after the date of the debt assumption, the refinancing issue is not treated as a refunding issue.

Section 1.150–1(b) of the current regulations provides that the term *related party* means, in reference to a governmental unit or a 501(c)(3) organization, any member of the same controlled group. Section 1.150–1(e) of the current regulations provides that the term *controlled group* means a group of entities controlled directly or indirectly by the same entity or group of entities. The determination of control is made on the basis of all the relevant facts and circumstances. One entity or group of entities (the *controlling entity*) generally controls another entity or group of entities (the *controlled entity*) if the controlling entity possesses either of the following rights or powers and the rights or powers are discretionary and non-ministerial: (i) the right or power both to approve and to remove without cause a controlling portion of the governing body of the controlled entity; or (ii) the right or power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity.

Recently, questions have arisen regarding the application of these provisions with respect to certain issuances of bonds for 501(c)(3) organizations that operate hospital systems. In question, generally is whether bonds issued in connection with the combination of two or more 501(c)(3) organizations to refinance outstanding bonds should be characterized as refunding bonds. One question is how the change in obligor exception and the six-month exception should be applied when the obligor of the new issue becomes related to the obligor of the other issue as part of the refinancing transaction. Another question is whether the acquisition by a 501(c)(3) organization of the sole membership interest in another 501(c)(3) organization should be treated as an asset acquisition for purposes of the six-month exception. A third question is what assets should be treated as financed by the new bonds under both the change in obligor exception and the six-month exception.

In general, the proposed regulations retain the change in obligor exception and the six-month exception, with certain modifications. The proposed regulations clarify that the determination of whether persons are related for purposes of the change in obligor exception and the six-month exception is generally made immediately before the transaction. However, a refinancing issue is a refunding issue under the proposed regulations if the obligor of the refinanced issue (or any person

that is related to the obligor of the refinanced issue immediately before the transaction) has or obtains in the transaction the right to appoint the majority of the members of the governing body of the obligor of the refinancing issue (or any person that controls the obligor of the refinancing issue).

The proposed regulations state that the six-month exception applies to *acquisition transactions*. An acquisition transaction is a transaction in which a person acquires from an unrelated party: (i) assets, other than an equity interest in an entity, if the acquirer is treated as acquiring such assets for all Federal income tax purposes; (ii) stock of a corporation with respect to which a valid election under section 338 is made; or (iii) control of a governmental unit or a 501(c)(3) organization through the acquisition of stock, membership interests or otherwise.

The proposed regulations retain the exclusion under which the six-month exception does not apply to transactions to which section 381(a) applies, and broaden its scope. In particular, under the proposed regulations the exclusion may apply even if the person assuming the obligations is not the acquiring corporation within the meaning of section 381(a) (for example, a transaction in which a corporation assumes the obligations of a target corporation in a transaction to which section 381(a) applies and then contributes all of the assets of the target corporation to a controlled subsidiary). The proposed regulations also extend the application of this rule for section 381(a) transactions to the change in obligor exception.

The proposed regulations provide two new, additional requirements for purposes of the change in obligor exception and the six-month exception. In certain circumstances where the obligors of the issues are affiliated before the transaction or become affiliated as part of the transaction, the proposed regulations provide that an issue will be treated as a refunding issue unless: (i) the refinanced issue is redeemed on the earliest date on which the issue may be redeemed, and (ii) the new issue is treated as being used to finance the assets that were financed with the proceeds of the refinanced issue. These new requirements are intended to further the Congressional policy against overburdening the tax-exempt bond market, as expressed in sections 148 and 149(d). In particular, they are intended to prevent overburdening in the case of transactions between affiliated persons that contain certain economic characteristics of a refunding.

Proposed Effective Date

The proposed regulations will apply to bonds sold on or after the date of publication of final regulations in the **Federal Register**. However, issuers may apply the proposed regulations in whole, but not in part, to any issue that is sold on or after the date the proposed regulations are published in the **Federal Register** and before the applicability date of the final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for July 30, 2002, at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by July 9, 2002, and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic by July 9, 2002.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Bruce M. Serchuk, Office of Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service and Stephen J. Watson, Office of Tax Legislative Counsel, Department of the Treasury. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.150–1 is amended as follows:

1. Paragraph (a)(2)(iii) is added.

2. Paragraphs (d)(2)(ii) and (d)(2)(v) are revised.

The added and revised provisions read as follows:

§ 1.150–1 Definitions.

(a) * * *

(2) * * *

(iii) *Special effective date for paragraphs (d)(2)(ii) and (d)(2)(v).* Paragraphs (d)(2)(ii) and (d)(2)(v) of this section apply to bonds sold on or after the

date of publication of final regulations in the **Federal Register**, and may be applied by issuers in whole, but not in part, to any issue that is sold on or after April 10, 2002.

* * * * *

(d) * * *

(2) * * *

(ii) *Certain issues with different obligors*—(A) *In general.* An issue is not a refunding issue to the extent that the obligor (as defined in paragraph (d)(2)(ii)(B) of this section) of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue. The determination of whether persons are related for this purpose is generally made immediately before the issuance of the refinancing issue. This paragraph (d)(2)(ii)(A) does not apply to any issue that is issued in connection with a transaction to which section 381(a) applies.

(B) *Definition of obligor.* The obligor of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment. The obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in § 1.148–1) does not include the ultimate recipient of the loan (*e.g.*, the homeowner, the student).

(C) *Certain integrated transactions.* If, within six months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an acquisition transaction (other than a transaction to which section 381(a) applies), the assumed issue is refinanced, the refinancing issue is not a refunding issue. An acquisition transaction is a transaction in which a person acquires from an unrelated party—

(*1*) Assets (other than an equity interest in an entity);

(*2*) Stock of a corporation with respect to which a valid election under section 338 is made; or

(*3*) Control of a governmental unit or a 501(c)(3) organization through the acquisition of stock, membership interests or otherwise.

(D) *Special rule for affiliated persons.* Paragraphs (d)(2)(ii)(A) and (C) of this section do not apply to any issue that is issued in connection with a transaction between affiliated persons (as defined in paragraph (d)(2)(ii)(E) of this section), unless—

(*1*) The refinanced issue is redeemed on the earliest date on which it may be redeemed (or otherwise within 90 days after the date of issuance of the refinancing issue); and

(*2*) The refinancing issue is treated for all purposes of sections 103 and 141 through 150 as financing the assets that were financed with the refinanced issue.

(E) *Affiliated persons.* For purposes of paragraph (d)(2)(ii)(D) of this section, persons are affiliated persons if—

(*1*) At any time during the six months prior to the transaction, more than 5 percent of the voting power of the governing body of either person is in the aggregate vested in the other person and its directors, officers, owners, and employees; or

(*2*) During the one-year period beginning six months prior to the transaction, the composition of the governing body of the acquiring person (or any person that controls the acquiring person) is modified or established to reflect (directly or indirectly) representation of the interests of the acquired person or the person from whom assets are acquired (or there is an agreement, understanding, or arrangement relating to such a modification or establishment during that one-year period).

(F) *Reverse acquisitions.* Notwithstanding any other provision of this paragraph (d)(2)(ii), a refinancing issue is a refunding issue if the obligor of the refinanced issue (or any person that is related to the obligor of the refinanced issue immediately before the transaction) has or obtains in the transaction the right to appoint the majority of the members of the governing body of the obligor of the refinancing issue (or any person that controls the obligor of the refinancing issue). See paragraph (d)(2)(v) *Example 2* of this section.

* * * * *

(v) *Examples.* The provisions of this paragraph (d)(2) are illustrated by the following examples:

Example 1. Consolidation of 501(c)(3) hospital organizations. (i) A and B are unrelated hospital organizations described in section 501(c)(3). A has assets with a fair market value of $175 million, and is the obligor of outstanding tax-exempt bonds in the amount of $75 million. B has assets with a fair market value of $145 million, and is the obligor of outstanding tax-exempt bonds in the amount of $50 million. In response to significant competitive pressures in the healthcare industry, and for other substantial business reasons, A and B agree to consolidate their operations. To accomplish the consolidation, A and B form a new 501(c)(3) hospital organization, C. A and B each appoint one-half of the members of the initial governing body of C. Subsequent to the initial appointments, C's governing body is self-perpetuating. On December 29, 2003, State Y issues bonds with sale proceeds of $129 million and lends the entire sale proceeds to C. The 2003 bonds are collectively secured by revenues of A, B, and C. Simultaneously with the issuance of the 2003 bonds, C acquires the sole membership interest in each of A and B. C's ownership of these membership interests entitles C to exercise exclusive control over the assets and operations of A and B. C uses the $129 million of sale proceeds of the 2003 bonds to defease the $75 million of bonds on which A was the obligor, and the $50 million of bonds on which B was the obligor. All of the defeased bonds will be redeemed on the first date on which they may be redeemed. In addition, C treats the 2003 bonds as financing the same assets as the defeased bonds. The 2003 bonds do not constitute a refunding issue because the obligor of the 2003 bonds (C) is neither the obligor of the defeased bonds nor a related party with respect to the obligors of those bonds immediately before the issuance of the 2003 bonds. In addition, the requirements of paragraph (d)(2)(ii)(D) of this section have been satisfied.

(ii) The facts are the same as in paragraph (i) of this *Example 1*, except that C acquires the membership interests in A and B subject to the obligations of A and B on their respective bonds, and the 2003 bonds are sold within six months after the acquisition by C of the membership interests. The 2003 bonds do not constitute a refunding issue.

Example 2. Reverse acquisition. D and E are unrelated hospital organizations described in section 501(c)(3). D has assets with a fair market value of $225 million, and is the obligor of outstanding tax-exempt bonds in the amount of $100 million. E has assets with a fair market value of $100 million. D and E agree to consolidate their operations. On May 18, 2004, Authority Z issues bonds with sale proceeds of $103 million and lends the entire sale proceeds to E. Simultaneously with the issuance of the 2004 bonds, E acquires the sole membership interest in D. In addition, D obtains the right to appoint the majority of the members of the governing body of E. E uses the $103 million of sale proceeds of the 2004 bonds to defease the bonds of which D was the obligor. All of the defeased bonds will be redeemed on the first date on which they may be redeemed. In addition, E treats the 2004 bonds as financing the same assets as the defeased bonds. The 2004 bonds constitute a refunding issue because the obligor of the defeased bonds (D) obtains in the transaction the right to appoint the majority of the members of the governing body of the obligor of the 2004 bonds (E). See paragraph (d)(2)(ii)(F) of this section.

Example 3. Relinquishment of control. The facts are the same as in *Example 2*, except that D does not obtain the right, directly or indirectly, to appoint any member of the governing body of E. Rather, E obtains the right both to approve and to remove

without cause each member of the governing body of D. In addition, prior to being acquired by E, D experiences financial difficulties as a result of mismanagement. Thus, as part of E's acquisition of D, all of the former members of D's governing body resign their positions and are replaced with persons appointed by E. The 2004 bonds do not constitute a refunding issue.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 5, 2002, 2:41 p.m., and published in the issue of the Federal Register for April 10, 2002, 67 F.R. 17309)

Notice of Proposed Rulemaking

Amendments to Rules for Determination of Basis of Partner's Interest; Special Rules

REG–167648–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to special rules on determination of basis of a partner's interest under section 705. The proposed regulations are necessary to coordinate sections 705 and 1032.

DATES: Written or electronic comments and requests for a public hearing must be received by June 27, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–167648–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–167648–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Barbara MacMillan or Rebekah A. Myers, (202) 622–3050; concerning submissions of comments or requests for a hearing, LaNita VanDyke at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On January 3, 2001, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–106702–00, 2001–4 I.R.B. 424) under section 705 of the Internal Revenue Code (Code) in the **Federal Register** (66 FR 315). Those proposed regulations provided guidance on the coordination of sections 705 and 1032 in situations where a corporation acquires an interest in a partnership that holds stock in that corporation, a section 754 election is not in effect with respect to the partnership for the taxable year in which the corporation acquires the interest, and the partnership later sells or exchanges the stock. Final regulations for the issues addressed in those proposed regulations are being published elsewhere in T.D. 8986. These proposed regulations propose to revise the final regulations contained in § 1.705–2 of 26 CFR part 1 to address remaining issues that Treasury and the IRS considered during the development of the final regulations.

Explanation of Provisions

These proposed regulations provide guidance in situations in which a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. For reasons similar to those explained in the preamble of the final regulations, in those situations it may be inconsistent with the intent of sections 705 and 1032 to increase the basis of the corporation's partnership interest by the full amount of any gain resulting from the partnership's sale or exchange of the stock which is not recognized by the corporation under section 1032.

Accordingly, the proposed regulations revise the purpose statement of § 1.705–2(a) to take into account situations involving such partnership distributions. The proposed regulations provide a specific rule implementing the revised purpose in single partnership cases. The proposed regulations also revise § 1.705–2(c) to clarify that the tiered partnerships rule applies to situations involving such partnership distributions.

In addition, the proposed regulations clarify that references in the regulations to stock of a corporate partner include any position in stock of a corporate partner to which section 1032 applies.

Proposed Effective Date

The regulations are proposed to apply to sales or exchanges of stock occurring after March 29, 2002.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying. A

public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Barbara MacMillan of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.705–1 is amended by revising paragraph (a)(7) to read as follows:

§ 1.705–1 Determination of basis of partner's interest.

(a) * * *

(7) For basis adjustments necessary to coordinate sections 705 and 1032 in certain situations in which a partnership disposes of stock or any position in stock to which section 1032 applies of a corporation that holds a direct or indirect interest in the partnership, see § 1.705–2.

* * * * *

Par. 3. Section 1.705–2 is amended as follows:

1. Paragraph (a) is amended by adding a new sentence after the third sentence.

2. Paragraph (b) is amended by adding paragraph (b)(2).

3. Paragraph (c)(1) is amended by adding a new sentence after the second sentence.

4. Paragraph (d) is added.

5. Paragraph (e) is amended by removing the period at the end of the paragraph and adding a new phrase at the end of the paragraph.

The additions and revision read as follows:

§ 1.705–2 Basis adjustments coordinating sections 705 and 1032.

(a) * * * Similarly, in situations where a section 754 election was not in effect for the year in which a partnership distributes money or other property to another partner and that partner recognizes gain on the distribution, the remaining partners' inside basis and outside basis may not be equal. * * *

* * * * *

(b) * * *

(2) *Required adjustments relating to distributions.* (i) This paragraph (b)(2) applies in situations where a corporation owns a direct or indirect interest in a partnership that owns stock in that corporation, the partnership distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, and the partnership subsequently sells or exchanges the stock. In these situations, the increase (or decrease) in the corporation's adjusted basis in its partnership interest resulting from the sale or exchange of the stock equals the amount of gain (or loss) that the corporate partner would have recognized (absent the application of section 1032) if, for the year in which the partnership made the distribution, a section 754 election had been in effect.

(ii) The provisions of this paragraph (b)(2) are illustrated by the following example:

Example. (i) A, B, and corporation C form partnership PRS. A and B each contribute $10,000 and C contributes $20,000 in exchange for a partnership interest. PRS has no liabilities. PRS purchases stock in corporation C for $10,000, which appreciates in value to $70,000. PRS distributes $25,000 to A in complete liquidation of A's interest in PRS in a year for which an election under section 754 is not in effect. PRS later sells the C stock for $70,000. PRS realizes a gain of $60,000 on the sale of the C stock. C's share of the gain is $40,000. Under section 1032, C does not recognize its share of the gain.

(ii) Normally, C would be entitled to a $40,000 increase in the basis of its PRS interest for its allocable share of PRS's gain from the sale of the C stock, but a special rule applies in this situation. If a section 754 election had been in effect for the year in which PRS made the distribution to A, PRS would have been entitled to adjust the basis of partnership property under section 734(b)(1)(A) by $15,000 (the amount of gain recognized by A with respect to the distribution to A under section 731(a)(1)). See § 1.734–1(b). Under § 1.755–1(c)(1)(ii), the basis adjustment under section 734(b) would have been allocated to the C stock, increasing its basis to $25,000. (Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.)

(iii) If a section 754 election had been in effect for the year in which PRS made the distribution to A, the amount of gain that PRS would have recognized upon PRS's disposition of C stock would be $45,000 ($70,000 minus $25,000 basis in the C stock), and the amount of gain C would have recognized upon PRS's disposition of the C stock (absent the application of section 1032) would be $30,000 (C's share of PRS's gain of $45,000 from the stock sale). Accordingly, upon PRS's sale of the C stock, the increase in the basis of C's interest in PRS is $30,000.

* * * * *

(c)(1) * * * Similarly, if a corporation owns an indirect interest in its own stock through a chain of two or more partnerships, and a partnership in the chain distributes money or other property to another partner and that partner recognizes gain on the distribution during a year in which the partnership does not have an election under section 754 in effect, then upon any subsequent sale or exchange of the stock, the bases of the interests in the partnerships included in the chain shall be adjusted in a manner that is consistent with the purpose of this section.

* * * * *

(d) *Positions in Stock.* For purposes of this section, stock includes any position in stock to which section 1032 applies.

(e) * * * , except that the fourth sentence of paragraph (a), paragraph (b)(2), and the third sentence of paragraph (c)(1) of this section are applicable with respect to sales or exchanges of stock occurring on or after March 29, 2002.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on March 28, 2002, 8:45 a.m., and published in the issue of the Federal Register for March 29, 2002, 67 F.R. 15132)

Hospital Refinancing Closing Agreement Program

Announcement 2002–43

Purpose

The Internal Revenue Service (the "Service"), Office of Tax Exempt Bonds, announces a program under which certain issuers of state or local bonds may request a closing agreement pursuant to which bonds (the "refinancing bonds") issued to refinance certain outstanding bonds (the "refinanced bonds") will be recognized as acquisition bonds (and therefore will not be treated as a refunding issue under § 1.150–1(d) of the Income Tax Regulations) and the allocations of proceeds to expenditures for such bonds will be respected.

Background

The closing agreement program applies to issues of state or local bonds issued in connection with hospital affiliation transactions where two or more existing 501(c)(3) organizations (the "Sellers") agreed to merge their operations by selling either the assets of the Sellers or control of the Sellers to a new or pre-existing 501(c)(3) organization that the Sellers jointly control. In particular, the program applies where the issuer did not characterize the refinancing bonds as a refunding issue under § 1.150–1(d)(2) and did not treat proceeds of the refinancing bonds as being used for all of the purposes for which the proceeds of the refinanced bonds were used. The Service is providing the program because it recognizes the policy reasons for the hospital affiliation transactions and the uncertainty in applying the allocation rules and has a desire to quickly and fairly resolve the examinations of the refinancing bonds.

On April 10, 2002, proposed regulations were published relating to the definition of refunding under § 1.150–1(d). Issuers may apply the proposed regulations in whole, but not in part, to any issue that is sold on or after the date the proposed regulations were published in the Federal Register and before the effective date of the final regulations.

Closing Agreement Procedure

An issuer seeking relief must execute a closing agreement with the Service on or before December 31, 2002, following the procedures in this announcement. An issue of bonds is eligible for the program whether or not it is under examination. The closing agreement will be prepared by the Service and, in general, will be in substantially the same form as the model closing agreement set forth in IRM 7.6.2. For issues that are not under examination, issuers should submit a request for closing agreement pursuant to Notice 2001–60 (2001–40 I.R.B. 304).

As a condition to executing a closing agreement, the issuer must agree to take one of the following actions:

1. Pay, simultaneously with the execution by the issuer of the closing agreement, the applicable closing agreement amount (as described below). Proceeds of tax-exempt bonds may not be used to pay the closing agreement amount.

2. Treat the proceeds of the refinancing bonds as used for the purposes for which the proceeds of the refinanced issue were used and restructure the refinancing bonds in a manner such that the bonds comply with the applicable requirements of §§ 103 and 141 through 150 of the Internal Revenue Code that are impacted by such allocation.

Closing Agreement Amount

The closing agreement amount is equal to 30 percent of the present value of the arbitrage profit on the escrow investments that were purchased with the proceeds of the refinancing bonds to be used to repay the refinanced bonds, plus interest accruing at the underpayment rate under § 6621, beginning on the date that is 60 days from April 10, 2002. Arbitrage profit is the excess of the amount earned on the escrow investments over the amount that would have been earned if the investments bore a yield equal to the yield on the refinancing bonds. Present value is computed as of the issue date of the refinancing bonds, using the yield on the refinancing bonds as the discount rate.

Yield on an issue will be equal to the yield on the issue under § 148. If all or a portion of the refinancing bonds bear interest at a variable rate, the variable rate will be equal to the actual values of the variable rate of the refinancing bonds from the issue date until the date of any closing agreement, and the reasonably expected values of the variable rate for the remaining term of the refinancing bonds. Expectations regarding values will be treated as reasonable if the values are equal to the value of an objective index of tax-exempt variable rates (similar to the variable rate on the refinancing bonds) on the date of the closing agreement.

Restructuring Option

Any restructuring must be completed within 180 of days of the execution of the closing agreement. To the extent that a restructuring involves the redemption of bonds, the issuer must provide a written notice to the bondholders similar to the notice described in § 5.02(5) of Rev. Proc. 97–15 (1997–1 C.B. 635).

Allocations of proceeds to bonds for non-qualified purposes of § 145(a)(2) will be treated as reasonable if made consistently with the rule set forth in § 1.141–12(j)(2).

Submissions

Submissions with regard to the closing agreement program should be directed to:

Clifford J. Gannett
Manager, Outreach, Planning
and Review
Internal Revenue Service
Attn: T:GE:TEB:O, Room 5T2
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Drafting Information

The principal authors of this announcement are Bruce M. Serchuk of the Office of Associate Chief Counsel (Tax Exempt and Government Entities) and W. Mark Scott of the Office of Tax Exempt Bonds, Tax Exempt and Government Entities Division. For further information regarding this announcement, contact W. Mark Scott at (202) 283–9815 (not a toll-free call).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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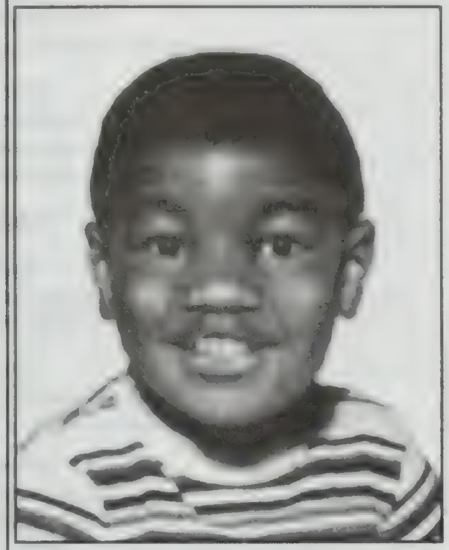

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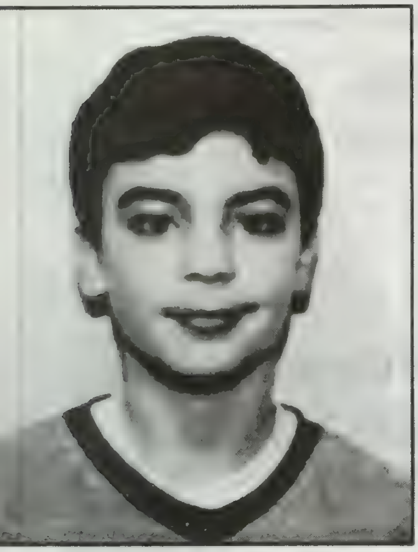

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Bulletin No. 2002–17
April 29, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

SPECIAL ANNOUNCEMENT

Announcement 2002–48, page 809.
New IRS brochure entitled Home-Based Business Tax Avoidance Schemes. . .At A Glance. The schemes described in the document claim to offer tax "relief," but actually result in illegal tax avoidance. The promoters of these schemes claim that by setting up a bogus home-based business, individual taxpayers can deduct most, or all, of their personal expenses as business expenses.

INCOME TAX

Rev. Rul. 2002–20, page 794.
Charitable remainder trusts; qualified charitable remainder unitrusts; recipient trusts. This ruling provides that, in three situations, a charitable remainder unitrust may pay the unitrust amounts to a second trust for the life of an individual, who is financially disabled as defined in section 6511(h)(2)(A) of the Code. In each situation, the use of the unitrust amounts by the second trust is consistent with the manner in which the individual's own assets would be used, and the individual is, therefore, considered to have received the unitrust amounts directly from the charitable remainder unitrust for purposes of section 664(d)(2)(A). Rev. Rul. 76–270 amplified and superseded.

Rev. Rul. 2002–21, page 793.
Low-income housing credit; tax-exempt bond financing. Amounts received from investing proceeds of tax-exempt bonds are counted toward satisfying the 50-percent aggregate basis test under section 42(h)(4)(B) of the Code.

Notice 2002–29, page 797.
Section 469 and gain recognition election. This document explains the effect under section 469 of the Code of a deemed sale of property on January 1, 2001, pursuant to an election under section 311(e) of the Taxpayer Relief Act of 1997.

Announcement 2002–44, page 809.
Electronic submission of Form 8850. This document announces that Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits,* may be submitted electronically to State Employment Security Agencies (SESAs) and sets forth the requirements that any electronic system must meet.

ADMINISTRATIVE

Notice 2002–20, page 796.
Industry Issue Resolution Program. This document announces that the Industry Issue Resolution (I I R) Program, a pilot program aimed at resolving contentious tax issues involving business, is being made permanent and expanded to be available to all business taxpayers. Taxpayers as well as industry associations and other groups representing taxpayers are invited to suggest issues and possible options for resolution.

(Continued on the next page)

Announcements of Declaratory Judgment Proceedings Under Section 7428 begin on page 810.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

Notice 2002–30, page 797.

Credit for sales of fuel produced from a nonconventional source, inflation adjustment factor, and reference price. This notice publishes the nonconventional source fuel credit, inflation adjustment factor, and reference price under section 29 of the Code for calendar year 2001. This data is used to determine the credit allowable on sales of fuel produced from a nonconventional source.

Rev. Proc. 2002–24, page 798.

Qualified mortgage bonds; mortgage credit certificates; national median gross income. Guidance is provided concerning the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f) of the Code. Rev. Proc. 2001–35 obsoleted, except as provided in section 5.02 of this procedure.

Rev. Proc. 2002–25, page 800.

This procedure sets forth the maximum face amount of qualified zone academy bonds that may be issued by each state, the District of Columbia, and the possessions of the United States during 2002.

Rev. Proc. 2002–27, page 802.

Depreciation of tires. This document provides a safe harbor method of accounting (the original tire capitalization method) for the cost of original and replacement tires for certain vehicles owned by taxpayers, procedures for a qualifying taxpayer to obtain automatic consent from the Commissioner to change to the original tire capitalization method, and an optional procedure for certain qualifying taxpayers to settle open taxable years using the original tire capitalization method. Rev. Proc. 2002–9 modified and amplified.

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Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 25.—Interest on Certain Home Mortgages

26 CFR 1.25–4T: Qualified mortgage credit certificate program (temporary).

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 2002–24, page 798.

Section 42.—Low-Income Housing Credit

26 CFR 1.42–1T: Limitation on low-income housing credit allowed with respect to qualified low-income buildings receiving housing credit allocations from a state or local housing credit agency (temporary). (Also §§ 103, 146.)

Low-income housing credit; tax-exempt bond financing. Amounts received from investing proceeds of tax-exempt bonds are counted toward satisfying the 50-percent aggregate basis test under section 42(h)(4)(B) of the Code.

Rev. Rul. 2002–21

ISSUE

Are amounts received from investing proceeds of tax-exempt bonds counted toward satisfying the 50-percent aggregate basis test under § 42(h)(4)(B) of the Internal Revenue Code?

FACTS

Partnership was formed to develop and operate in State *X* a low-income housing building in accordance with § 42. In December 1999, the State X bond-issuing authority (Issuer) issued at par $5.7 million of tax-exempt housing bonds, and loaned the $5.7 million to Partnership to finance a portion of the construction of the low-income housing project. Issuer received an allocation of § 146 volume cap in the amount of $5.7 million for the bonds. Principal payments on this financing are to be applied within a reasonable period to redeem the bonds.

Partnership's aggregate basis for the building and the land on which the building is located is $11.8 million. Partnership earned $300,000 in investment earnings from investing the original $5.7 million of proceeds of the bonds. The sum of these amounts, $6 million, was expended on construction of the building.

LAW AND ANALYSIS

Section 42(a) provides for a tax credit for investment in qualified low-income residential rental buildings placed in service after December 31, 1986.

Section 42(h)(1)(A) provides that the amount of credit determined under § 42 for any taxable year with respect to any building shall not exceed the housing credit dollar amount allocated to the building under § 42(h).

Section 42(h)(4)(A) provides that § 42(h)(1) does not apply to any portion of the credit otherwise allowable under § 42(a) which is attributable to eligible basis financed by any obligation the interest on which is exempt from tax under § 103 if—

(i) the obligation is taken into account under § 146, and

(ii) principal payments on the financing are applied within a reasonable period to redeem obligations the proceeds of which were used to provide the financing.

Section 42(h)(4)(B) provides that, if 50 percent or more of the aggregate basis of any building and the land on which the building is located is financed with tax-exempt obligations specified in § 42(h)(4)(A), § 42(h)(1) does not apply to any portion of the low-income housing credit allowable under § 42(a) with respect to the building.

Section 1.42–1T(f)(1) of the temporary Income Tax Regulations provides that no housing credit allocation is required in order to claim a credit under § 42 with respect to the entire qualified basis (as defined in § 42(c)) of a qualified low-income building if 70 percent or more of the aggregate basis of the building and the land on which the building is located is financed with the proceeds of tax-exempt bonds which are taken into account for purposes of the volume cap under § 146. The reference to 70 percent in § 1.42–1T(f)(1) has been superseded by an amendment to § 42(h)(4)(B), which changed 70 percent to 50 percent. Revenue Reconciliation Act of 1989, P.L. 101–239, § 7108(j).

Except as otherwise provided, § 103 provides that gross income does not include interest on any state or local bond. An exception under § 103(b)(1) is that interest on a private activity bond is included in gross income unless it is a qualified bond within the meaning of § 141. Generally, § 141(e)(2) requires that a qualified bond meet the volume cap requirements of § 146.

Section 146(a) provides that a private activity bond issued as part of an issue meets the volume cap requirements if the aggregate face amount of the private activity bonds issued pursuant to the issue, when added to the aggregate face amount of tax-exempt private activity bonds previously issued by the issuing authority during the calendar year, does not exceed the authority's volume cap for the calendar year.

Proceeds is not specifically defined for purposes of § 1.42–1T(f)(1). However, for other purposes of the Code, tax-exempt bond proceeds are generally defined to include amounts received from investing proceeds. See § 1.148–1(b) of the Income Tax Regulations. Accordingly, given the similarity of purposes for determining bond proceeds under § 1.42–1T(f)(1) and the tax-exempt bond provisions of the Code, it is appropriate to treat proceeds for purposes of § 1.42–1T(f)(1) to include amounts received from investing proceeds.

In the present situation, Partnership properly includes the $300,000 amount from investing proceeds to determine if it met the 50-percent aggregate basis test in § 42(h)(4)(B). Because $6 million ($5,700,000 plus $300,000) is greater than 50 percent of the aggregate basis of the building and the land ($11,800,000), Partnership satisfies the 50-percent test in § 42(h)(4)(B).

HOLDING

Amounts received from investing proceeds of tax-exempt bonds are counted toward satisfying the 50-percent aggregate basis test under § 42(h)(4)(B).

DRAFTING INFORMATION

The principal author of this revenue ruling is Jack Malgeri of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Malgeri at (202) 622–3040 (not a toll-free number).

Section 103.—Interest on State and Local Bonds

26 CFR 1.103–1: Interest upon obligations of a state, territory, etc.

Are amounts received from investing proceeds of tax-exempt bonds counted toward satisfying the 50-percent aggregate basis test under § 42(h)(4)(B) of the Internal Revenue Code? See Rev. Rul. 2002–21, page 793.

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 2002–24, page 798.

Section 143.—Mortgage Revenue Bonds: Qualified Mortgage Bond and Qualified Veterans' Mortgage Bond

26 CFR 6a.103A–2: Qualified mortgage bond.

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 2002–24, page 798.

Section 146.—Volume Cap

Are amounts received from investing proceeds of tax-exempt bonds counted toward satisfying the 50-percent aggregate basis test under § 42(h)(4)(B) of the Internal Revenue Code? See Rev. Rul. 2002–21, page 793.

Section 167.—Depreciation

If a taxpayer has a depreciable interest in a qualifying vehicle and chooses to account for the cost of original and replacement tires under the original tire capitalization method, are the qualifying vehicle's tires treated as part of the vehicle for depreciation purposes? See Rev. Proc. 2002–27, page 802.

Section 168.—Accelerated Cost Recovery System

Under the original tire capitalization method, what is the applicable depreciation method, recovery period, and convention for the cost of a qualifying vehicle's original tires for purposes of § 168 of the Internal Revenue Code? See Rev. Proc. 2002–27, page 802.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446.1: General rule for methods of accounting.

If a taxpayer changes its treatment of the cost of a qualifying vehicle's original and replacement tires to the original tire capitalization method, is this change a change in method of accounting under § 446(e) of the Internal Revenue Code? See Rev. Proc. 2002–27, page 802.

Section 481.—Adjustments Required by Changes in Method of Accounting

26 CFR 1.481–1: Adjustments in general.

If a taxpayer changes its treatment of the cost of a qualifying vehicle's original and replacement tires to the original tire capitalization method, is an adjustment under § 481 of the Internal Revenue Code taken into account in computing taxable income? See Rev. Proc. 2002–27, page 802.

Section 664.—Charitable Remainder Trusts

26 CFR 1.664–3: Charitable remainder unitrust.

Charitable remainder trusts; qualified charitable remainder unitrusts; recipient trusts. This ruling provides that, in three situations, a charitable remainder unitrust may pay the unitrust amounts to a second trust for the life of an individual, who is financially disabled as defined in section 6511(h)(2)(A) of the Code. In each situation, the use of the unitrust amounts by the second trust is consistent with the manner in which the individual's own assets would be used, and the individual is, therefore, considered to have received the unitrust amounts directly from the charitable remainder unitrust for purposes of section 664(d)(2)(A).

Rev. Rul. 2002–20

ISSUE

May a trust qualify as a charitable remainder unitrust under § 664 of the Internal Revenue Code, if the unitrust amounts are paid to a separate trust for the life of an individual who is "financially disabled," as defined in § 6511(h)(2)(A)?

FACTS

An individual concurrently creates Trust *A*, a trust that otherwise qualifies as a charitable remainder unitrust, and a separate trust, Trust *B*. Under the governing instrument of Trust *A*, annual unitrust amounts will be paid to Trust *B* for the life of *C*. *C* is an individual who is financially disabled, that is, *C* is unable to manage *C*'s own financial affairs by reason of a medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months.

Situation 1. Under the governing instrument of Trust *B*, a designated portion of the amount it receives from Trust *A* will be paid to *C* each month. If, at any time in the sole judgment of the trustee, the monthly payment to *C* is insufficient to provide adequately for the care, support, and maintenance of *C*, or is insufficient for the needs of *C* for any reason, additional amounts will be paid as needed to or on behalf of *C* from Trust *B*. Upon *C*'s death, the balance remaining in Trust *B* will be distributed to *C*'s estate.

Situation 2. Under the governing instrument of Trust *B*, the trustee may make distributions of income and principal, as determined in the trustee's sole and absolute discretion, for the financial aid and best interests of *C* in a manner

that supplements but does not supplant any governmental benefits otherwise available to *C*. Upon *C*'s death, the balance remaining in Trust *B* will be distributed to *C*'s estate.

Situation 3. Under the governing instrument of Trust *B*, the trustee may make distributions of income and principal, as determined in the trustee's sole and absolute discretion, for the financial aid and best interests of *C* in a manner that supplements but does not supplant any governmental benefits otherwise available to *C*. Upon *C*'s death, the governing instrument requires the trustee to reimburse the state for the total costs of medical assistance provided to *C* under the state's Medicaid plan. *C* is given a testamentary general power of appointment over the balance remaining in Trust *B*. If *C* fails to exercise the power, the balance will be distributed, in equal shares, to *C*'s sister and to *X*, a charitable organization.

LAW AND ANALYSIS

A charitable remainder unitrust is a trust from which a unitrust amount is payable at least annually during its term with an irrevocable remainder interest held for the benefit of charity. Under § 664 (d)(2)(A), the unitrust amount is a fixed percentage (not less than 5 percent and not more than 50 percent) of the net fair market value of the trust assets, valued annually. The unitrust amount is to be paid to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of the individual or individuals.

Section 1.664–3(a)(5)(i) of the Income Tax Regulations provides that the period for which the unitrust amount is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in § 170(c) may receive an amount for the life of an individual.

In general, a charitable remainder unitrust may pay unitrust amounts to a second trust only for a term of 20 years or less. In *Situations 1*, *2*, and *3*, the unitrust amounts are payable to Trust *B* for the life of *C*, not for a term of years. However, in each of these situations, the sole function of Trust *B* is to receive and administer the unitrust amounts for the benefit of *C*, who is unable to manage *C*'s own financial affairs by reason of a medically determinable mental or physical impairment. Upon *C*'s death, the assets remaining in Trust *B* will be distributed either to *C*'s estate or, after reimbursing the state for any Medicaid benefits provided to *C*, will be subject to *C*'s general power of appointment. In these situations, the use of the assets in Trust *B* during *C*'s life and at *C*'s death is consistent with the manner in which *C*'s own assets would be used. *C*, therefore, is considered to have received the unitrust amounts directly from Trust *A* for purposes of § 664 (d)(2)(A). Accordingly, the term of Trust *A* may be for the life of *C* and is not limited to a term of years.

The same result would apply if Trust *A* were a charitable remainder annuity trust.

HOLDING

A trust may qualify as a charitable remainder unitrust under § 664 if the unitrust amounts will be paid for the life of a financially disabled individual to a separate trust that will administer these payments on behalf of that individual and, upon the individual's death, will distribute the remaining assets either to the individual's estate or, after reimbursing the state for any Medicaid benefits provided to the individual, subject to the individual's general power of appointment.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 76–270 (1976–2 C.B. 194) which addresses facts covered by *Situation 1*, is amplified and superseded.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jan Bennett Geier of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Ms. Geier at (202) 622–7830 (not a toll-free call).

Section 1397E.—Credit to Holders of Qualified Zone Academy Bonds

What is the allocation for each State, the District of Columbia, and each possession of the United States of the national limitation amount of Qualified Zone Academy Bonds for calendar year 2002? See Rev. Proc. 2002–25, page 800.

Part III. Administrative, Procedural, and Miscellaneous

Industry Issue Resolution Program

Notice 2002–20

1. INTRODUCTION

This Notice invites submission of issues by taxpayers, representatives and associations for resolution under the Internal Revenue Service's *Industry Issue Resolution (IIR) Program*. Notice 2000–65 (2000–2 C.B. 599), announced the Industry Issue Resolution Pilot Program. The objective of the pilot program was to provide guidance to resolve frequently disputed tax issues common to a significant number of large or mid-size business taxpayers. This effort was part of the IRS's strategy to resolve issues in a manner other than the traditional post-filing examination process. Seven issues of the twenty-four submitted were selected for the pilot program. Thus far, five of the projects have resulted in published guidance.

After evaluating the pilot program and concluding that it was highly successful, the Service has determined that the IIR program should be made permanent. The objective is to provide guidance to resolve frequently disputed or burdensome issues and the program is expanded to address issues common to any size business taxpayers. The Large and Mid-Size Business Division (LMSB) and Small Business/Self-Employed Division (SB/SE) will jointly undertake the operational responsibility for the projects in the program. Resolution of contentious issues other than by the examination process is a strategic goal of both LMSB and SB/SE.

Taxpayers, as well as industry associations and other groups representing taxpayers, are invited to suggest issues and possible options for resolution. Parties submitting suggestions may be asked to meet with government representatives and to provide additional information. After analysis and review, the Service, the Office of Chief Counsel, and Treasury intend to select issues to address in the IIR program.

The form of resulting guidance may vary depending on the issue. However, the most likely form of guidance will be a Revenue Ruling or a Revenue Procedure that permits taxpayers to adopt a recommended treatment of the issue on future returns. In many cases, this may require filing a request for a change in method of accounting. For examples of the types of guidance that could be issued under this permanent program, see those published as a result of the IIR pilot program on the Digital Daily at *www.irs.gov*.

Suggestions for issues for the IIR program should be forwarded as provided in section 3 of this Notice by April 30, 2002. LMSB, SB/SE, the Office of Chief Counsel and Treasury will evaluate the suggestions with a view to selecting issues drawn from diverse industries. In reviewing potential issues for the program, the selection criteria will include the suitability of the issue for the program, the likelihood that timely guidance can be provided, and the availability of appropriate staffing and other resources. Projects selected for the program are expected to be included on the Treasury and IRS Guidance Priorities List for the business plan year ending in 2003. The principal focus of the program is to resolve issues arising in future years. However, depending on the circumstances, resolution also may be provided for certain issues for prior years.

Parties whose topics are accepted will be notified and may be asked to provide additional information and legal analysis of the issue. The issues selected for the program will be announced publicly.

2. ISSUES APPROPRIATE FOR THE PROGRAM

The objective of the IIR program is to provide guidance to resolve frequently disputed or burdensome tax issues that are common to a significant number of business taxpayers. Therefore, issues most appropriate to the program generally will have two or more of the following characteristics:

- There is uncertainty about the appropriate tax treatment of a given factual situation.
- The uncertainty results in frequent, often repetitive examinations of the same issue.
- The uncertainty results in significant taxpayer burden.
- The issue is material and impacts a significant number of taxpayers, either within an industry or across industry lines.
- Factual determination is a major component of the issue.

The following issues are not suitable:

- Issues unique to one or a small number of taxpayers.
- Issues under the jurisdiction of the Commissioner, Tax Exempt and Government Entities Division (*e.g.*, employee plans).
- Issues regarding transactions that lack a *bona fide* business purpose or are done with a significant purpose of reducing or avoiding federal taxes.
- Issues involving transfer pricing or international tax treaties.

3. REQUESTING CONSIDERATION UNDER THE IIR PROGRAM

No particular format is required for submissions in response to this Notice. However, submissions should briefly describe the proposed issue and explain why there is a need for guidance. Submissions may include an analysis of how the issue may be resolved. In addition, submissions should state the number of taxpayers estimated to be affected by the issue. All submissions will be available for public inspection and copying in their entirety. Therefore, comments should not include taxpayer-specific information of a confidential nature. Letters should include the name and telephone number of a person to contact should further clarification be needed. Issues previously submitted under the pilot program, but not selected, must be resubmitted to be considered for this permanent program.

Submission of issues for resolution under the IIR program should be e-mailed to *PFTG2@IRS.gov*. Alternatively, submissions may be faxed or mailed to:

Internal Revenue Service
Att'n: Alex Shojay
Office of Pre-filing and Technical Services
Large and Mid-Size Business Division LM:PFTG
Mint Building. 3rd Floor M-3-330
1111 Constitution Avenue NW
Washington, DC 20224
Fax: 202–283–8406

4. ADDITIONAL INFORMATION ABOUT THE PROGRAM

Project staffing. The Service and Treasury will staff each project with a team (the IIR team) that will analyze such information as may be appropriate and propose a resolution. This resolution will require the approval of those officials normally responsible for approving the type of guidance to be issued. IIR team members will include appropriate personnel from LMSB and SB/SE, the Office of Chief Counsel, Appeals and Treasury. Other Service personnel, as needed, also may be team members. In some circumstances, the Service may find it necessary to hire outside experts.

Communication with requesting taxpayer or group and other interested parties. As part of its efforts to formulate a recommendation for a resolution position, the IIR team may meet with the submitting taxpayer or group, and possibly with other interested parties. It is anticipated that the submitting party and other interested parties will be given the opportunity to present factual data and legal analysis. The IIR team may seek additional factual development or legal analysis from the submitting party or other sources.

Any solicitation of input from affected persons will be done within the requirements of the Federal Advisory Committee Act (FACA). The Service does not intend to form advisory committees during this process. Input is welcome from interested parties, but they will not be invited to enter into negotiations or to participate in the decision-making process with respect to the proposed resolution of the issue.

Potential inspection of books and records. An IIR team may consider the inspection of an individual taxpayer's records desirable as part of the factual research necessary to develop its position. Although a team may request such inspection, any such inspection will be voluntary. Any inspection of a taxpayer's records under this program, whether at the initiative of the taxpayer or the team, will not preclude or impede (under § 7605(b) of the Internal Revenue Code or any IRS administrative provisions) a later examination or inspection of records with respect to any tax year nor subject the IRS to any procedural restrictions (such as providing notice under § 7605(b)) that otherwise might apply before beginning such examination or inspection.

Disclosure of information provided by interested parties. Interested parties are encouraged to provide whatever information is necessary to permit the Service and Treasury to reach an appropriate resolution of an issue. However, this information may be subject to disclosure under the Freedom of Information Act (FOIA).

5. FURTHER INFORMATION

For further information regarding this notice, contact Susan Blake, Senior Program Analyst, of the LMSB Pre-filing and Technical Services Office at (202) 283–8414 (not a toll-free number).

Section 469 and Gain Recognition Election Notice

Notice 2002–29

This notice explains the effect under § 469 of the Internal Revenue Code of a deemed sale of property on January 1, 2001, pursuant to an election under § 311(e) of the Taxpayer Relief Act of 1997 (TRA 97) (1997–4 (Vol. 1) C. B. 1, 49–50).

Section 1(h), as amended in 1997, provides for a reduced capital gains rate for qualified 5-year gain. Section 1(h)(2)(B)(ii) limits the amount of qualified 5-year gain to that determined by taking into account only property for which the holding period begins after December 31, 2000. Section 311(e) of TRA 97 provides that a noncorporate taxpayer may elect to treat a capital asset or property used in the trade or business (as defined in § 1231(b) of the Code) held by the taxpayer on January 1, 2001, as having been sold on January 1, 2001, for an amount equal to its fair market value and as having been reacquired for an amount equal to its fair market value on the same date (mark-to-market election).

Section 469(g)(1)(A) provides that, if a taxpayer disposes of the taxpayer's entire interest in any passive activity (or former passive activity) in a fully taxable transaction that does not involve a disposition to a related party, then the excess of the loss from the activity for the taxable year (including any suspended passive activity loss) over any net income or gain for the taxable year from all other passive activities shall be treated as a loss which is not from a passive activity. As a result, if § 469(g)(1)(A) applies, the excess loss from the activity over any net income from all passive activities is no longer subject to the limitations of § 469.

A question has arisen whether electing a deemed sale of property under § 311(e) of TRA 97 is treated as a disposition of that property under § 469(g)(1)(A).

In a technical correction to § 311(e), § 414(a)(2) of the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107–147, 116 Stat. 21, clarifies that a mark-to-market election is not a disposition for purposes of § 469(g)(1)(A). Thus, the gain included in gross income by reason of a mark-to-market election may be passive activity gross income that can be offset by passive activity deductions, but the election does not otherwise affect the determination of the passive activity loss that is disallowed under § 469.

The principal author of this notice is Tara P. Volungis of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Volungis at (202) 622–3080 (not a toll-free call).

Nonconventional Source Fuel Credit, Section 29 Inflation Adjustment Factor, and Section 29 Reference Price

Notice 2002–30

This notice publishes the nonconventional source fuel credit, inflation adjustment factor, and reference price under § 29 of the Internal Revenue Code for calendar year 2001. These are used to

determine the credit allowable on fuel produced from a nonconventional source under § 29. The calendar year 2001 inflation-adjusted credit applies to the sales of barrel-of-oil equivalent of qualified fuels sold by a taxpayer to an unrelated person during the 2001 calendar year, the domestic production of which is attributable to the taxpayer.

BACKGROUND

Section 29(a) provides for a credit for producing fuel from a nonconventional source, measured in barrel-of-oil equivalent of qualified fuels, the production of which is attributable to the taxpayer and sold by the taxpayer to an unrelated person during the tax year. The credit is equal to the product of $3.00 and the appropriate inflation adjustment factor.

Section 29(b)(1) and (2) provides for a phaseout of the credit. The credit allowable under § 29(a) must be reduced by an amount which bears the same ratio to the amount of the credit (determined without regard to § 29(b)(1)) as the amount by which the reference price for the calendar year in which the sale occurs exceeds $23.50 bears to $6.00. The $3.00 in § 29(a) and the $23.50 and $6.00 must each be adjusted by multiplying these amounts by the 2001 inflation adjustment factor. In the case of gas from a tight formation, the $3.00 amount in § 29(a) must not be adjusted.

Section 29(c)(1) defines the term "qualified fuels" to include oil produced from shale and tar sands; gas produced from geopressurized brine, Devonian shale, coal seams, or a tight formation, or biomass; and liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.

Section 29(d)(1) provides that the credit is to be applied only for sale of qualified fuels the production of which is within the United States (within the meaning of § 638(1)) or a possession of the United States (within the meaning of § 638(2)).

Section 29(d)(2)(A) requires that the Secretary, not later than April 1 of each calendar year, determine and publish in the Federal Register the inflation adjustment factor and the reference price for the preceding calendar year.

Section 29(d)(2)(B) defines "inflation adjustment factor" for a calendar year as the fraction the numerator of which is the GNP implicit price deflator for the calendar year and the denominator of which is the GNP implicit price deflator for calendar year 1979. The term "GNP implicit price deflator" means the first revision of the implicit price deflator for the gross national product as computed and published by the Department of Commerce.

Section 29(d)(2)(C) defines "reference price" to mean with respect to a calendar year the Secretary's estimate of the annual average wellhead price per barrel for all domestic crude oil the price of which is not subject to regulation by the United States.

Section 29(d)(3) provides that in the case of a property or facility in which more than one person has an interest, except to the extent provided in regulations prescribed by the Secretary, production from the property or facility (as the case may be) must be allocated among the persons in proportion to their respective interests in the gross sales from the property or facility.

Section 29(d)(5) and (6) provides that the term "barrel-of-oil equivalent" with respect to any fuel generally means that amount of the fuel which has a Btu content of 5.8 million.

INFLATION ADJUSTMENT FACTOR AND REFERENCE PRICE

The inflation adjustment factor for calendar year 2001 is 2.0917. The reference price for calendar year 2001 is $21.86. These amounts will be published in the Federal Register on April 5, 2002.

PHASEOUT CALCULATION

Because the calendar year 2001 reference price does not exceed $23.50 multiplied by the inflation adjustment factor, the phaseout of the credit provided for in § 29(b)(1) does not occur for any qualified fuel sold in calendar year 2001.

CREDIT AMOUNT

The nonconventional source fuel credit under § 29(a) is $6.28 per barrel-of-oil equivalent of qualified fuels ($3.00 x 2.0917). This amount will be published in the Federal Register on April 5, 2002.

DRAFTING INFORMATION CONTACT

The principal author of this notice is Jaime Park of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Park at (202) 622–3120 (not a toll-free call).

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26 CFR 601.601: Rules and regulations.
(Also Part I, §§ 25, 103, 143; 1.25–4T, 1.103–1, 6a.103A–2.)

Rev. Proc. 2002–24

SECTION 1. PURPOSE

This revenue procedure provides guidance concerning the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5).

SECTION 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a "qualified bond" within the meaning of § 141. Section 141(e) provides that the term "qualified bond" includes any private activity bond that (1) is a qualified mortgage bond, (2) meets the volume cap requirements under § 146, and (3) meets the applicable requirements under § 147.

.02 Section 143(a)(1) provides that the term "qualified mortgage bond" means a bond that is issued as part of a "qualified mortgage issue". Section 143(a)(2)(A) provides that the term "qualified mortgage issue" means an issue of one or more bonds by a state or political subdivision thereof, but only if (i) all proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences; (ii) the issue meets the requirements of subsections (c), (d), (e), (f), (g), (h), (i), and (m)(7) of § 143; (iii) the issue does not meet the private business tests of

paragraphs (1) and (2) of § 141(b); and (iv) with respect to amounts received more than 10 years after the date of issuance, repayments of $250,000 or more of principal on financing provided by the issue are used not later than the close of the first semi-annual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 Section 143(f) imposes eligibility requirements concerning the maximum income of mortgagors for whom financing may be provided by qualified mortgage bonds. Section 25(c)(2)(A)(iii)(IV) provides that recipients of mortgage credit certificates must meet the income requirements of § 143(f). Generally, under §§ 143(f)(1) and 25(c)(2)(A)(iii)(IV), these income requirements are met only if all owner-financing under a qualified mortgage bond and all certified indebtedness amounts under a mortgage credit certificate program are provided to mortgagors whose family income is 115 percent or less of the applicable median family income. Under § 143(f)(6), the income limitation is reduced to 100 percent of the applicable median family income if there are fewer than three individuals in the family of the mortgagor.

.04 Section 143(f)(4) provides that the term "applicable median family income" means the greater of (A) the area median gross income for the area in which the residence is located or (B) the statewide median gross income for the state in which the residence is located.

.05 Section 143(f)(5) provides for an upward adjustment of the income limitations in certain high housing cost areas. Under § 143(f)(5)(C), a high housing cost area is a statistical area for which the housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined under § 143(f)(5)(D) by dividing (a) the applicable housing price ratio by (b) the ratio that the area median gross income bears to the median gross income for the United States. The applicable housing price ratio is the new housing price ratio (new housing average purchase price for the area divided by the new housing average purchase price for the United States) or the existing housing price ratio (existing housing average area purchase price divided by the existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1. This income adjustment applies only to bonds issued and nonissued bond amounts elected after December 31, 1988.

.06 The Department of Housing and Urban Development (HUD) has computed the median gross income for the United States, the states, and statistical areas within the states. The income information was released to the HUD regional offices on January 31, 2002, and may be obtained by calling the HUD reference service at 1–800–245–2691. The income information is also available at HUD's World Wide Web site, *http:huduser.org\datasets\il.html*, which provides a menu from which you may select the year and type of data of interest. The Internal Revenue Service annually publishes only the median gross income for the United States.

.07 The most recent nationwide average purchase prices and average area purchase price safe harbor limitations were published on September 6, 1994, in Rev. Proc. 94–55 (1994–2 C.B. 716).

SECTION 3. APPLICATION

.01 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use $54,400 as the median gross income for the United States. See section 2.06 of this revenue procedure.

.02 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use the area median gross income figures released by HUD on January 31, 2002. See section 2.06 of this revenue procedure.

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 2001–35 (2001–22 C.B. 1293) is obsolete except as provided in section 5.02 of this revenue procedure.

.02 This revenue procedure does not affect the effective date provisions of Rev. Rul. 86–124 (1986–2 C.B. 27). Those effective date provisions will remain operative at least until the Service publishes a new revenue ruling that conforms the approach to effective dates set forth in Rev. Rul. 86–124 to the general approach taken in this revenue procedure.

SECTION 5. EFFECTIVE DATES

.01 Issuers must use the United States and area median gross income figures specified in section 3 of this revenue procedure for commitments to provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period that begins on January 31, 2002, and ends on the date when these United States and area median gross income figures are rendered obsolete by a new revenue procedure.

.02 Notwithstanding section 5.01 of this revenue procedure, issuers may continue to rely on the United States and area median gross income figures specified in Rev. Proc. 2001–35 with respect to bonds originally sold and nonissued bond amounts elected not later than May 29, 2002, if the commitments or purchases described in section 5.01 are made not later than July 28, 2002.

DRAFTING INFORMATION

The principal author of this revenue procedure is Zoran Stojanovic of the Office of Assistant Chief Counsel (Exempt Organizations/Employment Tax/Government Entities). For further information regarding this revenue procedure, contact Mr. Stojanovic at (202) 622–3980 (not a toll-free call).

26 CFR 601.601: Rules and regulations.
(Also Part I, § 1397E.)

Rev. Proc. 2002–25

SECTION 1. PURPOSE

Pursuant to § 1397E(e)(2) of the Internal Revenue Code, this revenue procedure allocates among the States the 2002 national limitation amount of Qualified Zone Academy Bonds ("Bond" or "Bonds") that may be issued for the calendar year 2002. For this purpose "State" includes the District of Columbia and the possessions of the United States.

SECTION 2. BACKGROUND

.01 Section 226 of the Taxpayer Relief Act of 1997, Pub. L. 105–34, 111 Stat. 821 (1997), added § 1397E to the Internal Revenue Code to provide a credit to holders of Bonds under certain circumstances so that the Bonds generally can be issued without discount or interest. Ninety-five percent of Bond proceeds are to be used for qualified purposes, as defined by § 1397E(d)(5), with respect to a qualified zone academy, as defined by § 1397E(d)(4).

.02 Section 1397E(e)(1), as amended by § 608 of the Job Creation and Worker Assistance Act of 2002, Pub. L. 107–147, 116 Stat. 21 (2002), provides that the national limitation amount of Bonds that may be issued is $400 million for each of the years 1998, 1999, 2000, 2001, 2002, and 2003. This amount is to be allocated among the States by the Secretary on the basis of their respective populations below the poverty level (as defined by the Office of Management and Budget) and is to be further allocated by each State to qualified zone academies within the State.

.03 Section 1397E(e)(4), as amended, by § 509 of the Tax Relief Extension Act of 1999, Pub. L. 106–170, 113 Stat. 1860 (1999) provides that any carryforward of a limitation amount may be carried only to the first 2 years (3 years for carryforwards from 1998 or 1999) following the unused limitation year. For this purpose a limitation amount shall be treated as used on a first-in first-out basis.

.04 Rev. Proc. 98–9 (1998–1 C.B. 341), Rev. Proc. 98–57 (1998–2 C.B. 682), Rev. Proc. 2000–10 (2000–1 C.B. 287), and Rev. Proc. 2001–14 (2001–1 C.B. 343), respectively, allocated the national limitation for 1998, 1999, 2000, and 2001 among the States.

SECTION 3. NATIONAL QUALIFIED ZONE ACADEMY BOND LIMITATION FOR 2002

The 2002 national limitation amount for Bonds is $400 million. This amount is allocated among the States as follows:

STATE	MAXIMUM FACE AMOUNT OF BONDS THAT MAY BE ISSUED DURING 2002 (thousands of dollars)
ALABAMA	$ 7,683
ALASKA	634
ARIZONA	7,061
ARKANSAS	5,589
CALIFORNIA	53,149
COLORADO	4,105
CONNECTICUT	2,621
DELAWARE	862
DISTRICT OF COLUMBIA	898
FLORIDA	19,196
GEORGIA	10,400
HAWAII	1,376
IDAHO	1,927
ILLINOIS	16,827
INDIANA	6,032
IOWA	2,465
KANSAS	3,004
KENTUCKY	5,637
LOUISIANA	8,736
MAINE	1,269
MARYLAND	4,632
MASSACHUSETTS	7,528
MICHIGAN	11,884

STATE	MAXIMUM FACE AMOUNT OF BONDS THAT MAY BE ISSUED DURING 2002 (thousands of dollars)
MINNESOTA	3,411
MISSISSIPPI	4,284
MISSOURI	5,266
MONTANA	1,628
NEBRASKA	1,771
NEVADA	2,035
NEW HAMPSHIRE	766
NEW JERSEY	7,970
NEW MEXICO	3,578
NEW YORK	29,441
NORTH CAROLINA	10,903
NORTH DAKOTA	730
OHIO	13,847
OKLAHOMA	6,032
OREGON	4,572
PENNSYLVANIA	12,710
RHODE ISLAND	1,017
SOUTH CAROLINA	4,787
SOUTH DAKOTA	802
TENNESSEE	9,814
TEXAS	36,059
UTAH	2,537
VERMONT	850
VIRGINIA	6,391
WASHINGTON	7,097
WEST VIRGINIA	2,968
WISCONSIN	6,199
WYOMING	646
AMERICAN SAMOA	418
GUAM	426
NORTHERN MARIANAS	381
PUERTO RICO	26,727
VIRGIN ISLANDS	422

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective April 29, 2002, and applies to Bonds issued after March 9, 2002.

DRAFTING INFORMATION

The principal author of this revenue procedure is Zoran Stojanovic of the Office of Assistant Chief Counsel (Exempt Organizations/Employment Tax/Government Entities). For further information regarding this revenue procedure, contact Mr. Stojanovic at (202) 622–3980 (not a toll-free call).

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 167,168, 446, 481; 1.446–1, 1.481–1.)

Rev. Proc. 2002–27

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor method of accounting for the cost of original and replacement tires for certain vehicles (original tire capitalization method) used in various business activities. This revenue procedure also explains how a taxpayer can obtain automatic consent from the Commissioner of Internal Revenue to change to the original tire capitalization method, including rules relating to the limitations, terms, and conditions the Commissioner deems necessary to make the change. In addition, this revenue procedure provides an optional procedure for a taxpayer to settle open taxable years using the original tire capitalization method if the taxpayer's treatment of original and replacement tire expenditures is an issue under consideration in examination, before an area appeals office, or before the United States Tax Court (Tax Court) or is an issue pending in examination.

SECTION 2. BACKGROUND

.01 Section 162 of the Internal Revenue Code allows a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. However, § 263(a) prohibits a deduction for capital expenditures. Capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. Section 1.263(a)–2(a) of the Income Tax Regulations. These capital expenditures are subject to the allowance for depreciation.

.02 Section 167(a) provides a depreciation allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income. The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system (GDS) in § 168(a); and (2) the alternative depreciation system (ADS) in §168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention. For purposes of either GDS or ADS, the applicable recovery period is determined by reference to class life or by statute.

Rev. Proc. 87–56 (1987–2 C.B. 674) sets forth the class lives of property that are necessary to compute the depreciation allowances under § 168. The revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities.

.03 Several court decisions and revenue rulings have considered the expense-versus-capital expenditure issue regarding truck tires. In *W.H. Tompkins Co. v. Commissioner*, 47 B.T.A. 292 (1942), the court stated that the recovery of the cost of short-lived truck tires and tubes should not be associated with the depreciation of much longer-lived trucks because the tires and tubes are easily separable from the truck and are not a part of the truck's mechanism. The court held, therefore, that the cost of truck tires and tubes consumable within the taxable year are currently deductible as an expense in the year of purchase. *See also Zelco, Inc. v. Commissioner*, 331 F.2d 418, 421 (1st Cir. 1964) (a lessor of trailers and tractors used by interstate motor carriers was not required to treat those vehicles' tires as a part of the leased vehicles, and the cost of trailer and tractor tires and tubes with an average useful life of 12 months could be deducted currently); *Interstate Truck Service, Inc. v. Commissioner*, T.C. Memo. 1958–219 (a taxpayer in the motor freight transportation business can currently deduct the cost of tires and tubes on trucks, tractors, and trailers because on average all of the tires and tubes were consumable in less than one year). In Rev. Rul. 59–249 (1959–2 C.B. 55), the Service announced that it would follow the holdings of *Tompkins* and *Interstate* for tires purchased on new commercial trucking equipment and used in motor freight transportation. Rev. Rul. 68–134 (1968–1 C.B. 63) discusses *Zelco* and holds that the principles of Rev. Rul. 59–249 are applicable to tires in the case of a taxpayer who is a purchaser-lessor of new commercial trucking equipment.

Accordingly, truck, trailer, and tractor tires are not treated as part of the vehicle for depreciation purposes. Rather, these tires are considered to be separate assets and, as such, their cost is currently deductible by a taxpayer provided they are consumable in less than one year. However, the cost of truck, trailer, and tractor tires with an average useful life to a taxpayer of more than one year cannot be currently deducted as an operating expense. Their cost must be capitalized and recovered through depreciation. Because truck, trailer, and tractor tires are not considered part of the vehicle for depreciation purposes, they are not associated with any of the specific transportation assets included in the specific asset classes of Rev. Proc. 87–56 (that is, asset classes 00.241, 00.242, 00.26, and 00.27). Therefore, in accordance with § 168 and Rev. Proc. 87–56, all truck, trailer, and tractor tires that must be capitalized, whether original or replacement, are depreciated as assets used in specific business activities (that is, asset classes 01.1 through 80.0 of Rev. Proc. 87–56). For example, if a taxpayer's business activity is described in asset class 42.0, Motor Transport—Freight, original and replacement truck, trailer, and tractor tires, like the other assets in this class, would have a 5-year recovery period for GDS purposes and an 8-year recovery period for ADS purposes.

.04 Under § 446(b), the Commissioner has broad authority to determine whether a method of accounting clearly reflects income. If a taxpayer's method of accounting does not clearly reflect income, the computation of taxable income must be made under a method that, in the opinion of the Secretary, does clearly reflect income. *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) (1979–1 C.B. 167); *Commissioner v. Hansen*, 360 U.S. 446 (1959) (1959–2 C.B. 460); § 1.446–1(c)(2)(ii).

.05 Section 446(e) and § 1.446–1(e) provide that, except as otherwise provided, a taxpayer must secure the consent

of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting.

.06 Since the issuance of the court decisions and revenue rulings previously discussed, the quality of tires has improved significantly. Most tires manufactured in recent years have useful lives in excess of a year, although some taxpayers, because of the nature of their business activities, still consume their tires within a year. To minimize disputes regarding the useful lives of original tires and replacement tires for certain vehicles, the Internal Revenue Service will permit a taxpayer that complies with the requirements of this revenue procedure to account for the cost of original tires and replacement tires for certain vehicles using the original tire capitalization method described in section 5 of this revenue procedure.

SECTION 3. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure:

.01 *Qualifying Vehicle*. A qualifying vehicle is a vehicle for which depreciation is determined under § 168 and that is described in asset class 00.241, 00.242, 00.26, or 00.27 of Rev. Proc. 87–56, or a converter dolly (converter gear) for which depreciation is determined under § 168.

.02 *Original Tires*. Original tires are the first set of tires installed on a qualifying vehicle acquired by the taxpayer whether or not the vehicle was equipped with tires when acquired.

.03 *Replacement Tires*. Replacement tires are all other tires installed on a qualifying vehicle following acquisition of the vehicle by taxpayer.

SECTION 4. SCOPE

.01 This revenue procedure applies to a taxpayer that has a depreciable interest in its qualifying vehicles and that chooses to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the original tire capitalization method described in section 5 of this revenue procedure.

.02 A taxpayer that chooses not to account for the cost of original tires and replacement tires for all of its qualifying vehicles under the original tire capitalization method described in section 5 of this revenue procedure must account for the cost of these tires in accordance with section 2.03 of this revenue procedure.

SECTION 5. ORIGINAL TIRE CAPITALIZATION METHOD

.01 *In General*. Under the original tire capitalization method, a qualifying vehicle's tires are treated as part of the vehicle and not as separate assets. In addition, under the original tire capitalization method, the rotation of a tire from one vehicle to another (for example, from a tractor to a trailer) is not treated as a change in use within the meaning of § 168(i)(5). A taxpayer that uses the original tire capitalization method described in this section must use this method for the original and replacement tires of all of its qualifying vehicles.

.02 *Description of Method*. Under the original tire capitalization method, a taxpayer:

(1) must capitalize the cost of the original tires of a qualifying vehicle and depreciate these tires under § 168 by using the same depreciation method, recovery period, and convention applicable to the vehicle on which the tires are first installed;

(2) must treat the original tires of the qualifying vehicle as being disposed of at the same time the vehicle on which the tires were first installed is disposed of by the taxpayer; and

(3) must deduct the cost of the replacement tires of the qualifying vehicle as an expense in the taxable year the replacement tires are installed on the vehicle by the taxpayer.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

.01 *In General*. A change in a taxpayer's treatment of the cost of a qualifying vehicle's original tires and replacement tires is a change in method of accounting to which §§ 446 and 481 apply.

.02 *Issue Not Under Consideration or Not Pending*. If a taxpayer within the scope of this revenue procedure wants to change to the original tire capitalization method for its first or second taxable year ending on or after December 31, 2001, (year of change) and the treatment of its qualifying vehicle's original tires or replacement tires is not an issue under consideration in examination, before an area appeals office, or before a federal court (within the meaning of section 3.09 of Rev. Proc. 2002–9, 2002–3 I.R.B. 327, as modified by Rev. Proc. 2002–19, 2002–13 I.R.B. 696, and as modified and clarified by Announcement 2002–17, 2002–8 I.R.B. 561), or is not an issue pending in examination (within the meaning of section 6.03(6) of Rev. Proc. 2002–9), on April 3, 2002, the taxpayer must follow the automatic change in method of accounting provisions in Rev. Proc. 2002–9 (or its successor) with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply. If the taxpayer is under examination, before an area appeals office, or before a federal court regarding any income tax issue other than the treatment of its qualifying vehicle's original tires or replacement tires, the taxpayer must provide a copy of the Form 3115, *Application for Change in Accounting Method*, to the examining officer, appeals officer, or government counsel (whichever is applicable) at the same time it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining officer, appeals officer, or government counsel, as appropriate.

(2) To assist the Service in processing changes in method of accounting under this section of the revenue procedure, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002–9 is modified to require that a Form 3115 filed under this revenue procedure include the statement: "Automatic Change Filed Under Rev. Proc. 2002–27." This statement should be legibly printed or typed on the appropriate line on any Form 3115 filed under this revenue procedure.

(3) The change to the original tire capitalization method will be made using a "cut-off method." Under the cut-off method, only a qualifying vehicle's original and replacement tires placed in service by a taxpayer on or after the beginning of the year of change are accounted for under the original tire capitalization method. A qualifying vehicle's original and replacement tires placed in service by the taxpayer before the year of change continue to be accounted for under the taxpayer's former method of accounting. Because no items are duplicated or omitted from income when the cut-off method is used to effect a change in accounting method, no § 481(a) adjustment is necessary.

.03 *Issue Under Consideration or Issue Pending*. If a taxpayer within the scope of this revenue procedure wants to change to the original tire capitalization method for its year of change (as defined in section 6.02 of this revenue procedure) and the treatment of its qualifying vehicle's original tires or replacement tires is an issue under consideration in examination, before an area appeals office, or before a federal court (within the meaning of section 3.09 of Rev. Proc. 2002–9), or is an issue pending in examination (within the meaning of section 6.03(6) of Rev. Proc. 2002–9), on April 3, 2002, the taxpayer must follow the automatic change in method of accounting provisions in Rev. Proc. 2002–9 (or its successor) with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply. The taxpayer must provide a copy of the Form 3115 to the examining officer, appeals officer, or government counsel (whichever is applicable) at the same time it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining officer, appeals officer, or government counsel, as appropriate.

(2) To assist the Service in processing changes in method of accounting under this section of the revenue procedure, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002–9 is modified to require that a Form 3115 filed under this revenue procedure include the statement: "Automatic Change Filed Under Rev. Proc. 2002–27." This statement should be legibly printed or typed on the appropriate line on any Form 3115 filed under this revenue procedure.

(3) The change to the original tire capitalization method will be made using a cut-off method. Under the cut-off method, only a qualifying vehicle's original and replacement tires placed in service by a taxpayer on or after the beginning of the year of change are accounted for under the original tire capitalization method. A qualifying vehicle's original and replacement tires placed in service by the taxpayer before the year of change continue to be accounted for under the taxpayer's former method of accounting. But see section 6.03(4) of this revenue procedure. Because no items are duplicated or omitted from income when the cut-off method is used to effect a change in accounting method, no § 481(a) adjustment is necessary.

(4) Section 7 of Rev. Proc. 2002–9 does not apply. The taxpayer does not receive audit protection in connection with a change to the original tire capitalization method. Accordingly, the Service may require the taxpayer to change its method of accounting for a qualifying vehicle's original and replacement tires for any taxable year before the year of change.

.04 *Special Rule for Certain Taxpayers with Issue Under Consideration or Issue Pending*. If a taxpayer is within the scope of this revenue procedure and the treatment of its qualifying vehicle's original tires or replacement tires is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002–9) in examination, before an area appeals office, or before the Tax Court, or is an issue pending in examination (within the meaning of section 6.03(6) of Rev. Proc. 2002–9), on April 3, 2002, the taxpayer may change to the original tire capitalization method for its first or second taxable year ending on or after December 31, 2001, under section 6.03 of this revenue procedure or, alternatively, for an earlier taxable year under section 7 of this revenue procedure. See also section 6.05 of this revenue procedure for deemed consent situations.

.05 *Special Rule for Certain Taxpayers Deemed to Have Obtained Consent*. A taxpayer within the scope of this revenue procedure will be deemed to have obtained the consent of the Commissioner to change to the original tire capitalization method (as described in section 5 of this revenue procedure) for all of its qualifying vehicles' original tires and replacement tires placed in service before the year of change (as defined in section 6.02 of this revenue procedure) if: (1) the taxpayer treated these tires in the same manner as permitted under the original tire capitalization method in all taxable years since the tires were placed in service by the taxpayer; or (2) the taxpayer changed its treatment of these tires in a taxable year ending on or before December 31, 2001, for which an original federal income tax return has been filed as of April 3, 2002, to the original tire capitalization method, with or without a § 481(a) adjustment, and treated the tires under that method in all taxable years since the taxpayer changed to the original tire capitalization method. Any taxpayer described in this section 6.05 will be deemed to have obtained the consent of the Commissioner to change to the original tire capitalization method as of the beginning of the first taxable year in which the taxpayer used the original tire capitalization method, and is not required to file a Form 3115 under this section 6.

However, if the taxpayer's treatment of its qualifying vehicle's original tires or replacement tires is an issue under consideration in examination, before an area appeals office, or before a federal court (within the meaning of section 3.09 of Rev. Proc. 2002–9), or is an issue pending in examination (within the meaning of section 6.03(6) of Rev. Proc. 2002–9), on April 3, 2002, the taxpayer does not receive audit protection in connection with the change to the original tire capitalization method. Accordingly, the Service may require the taxpayer to change its method of accounting for a qualifying vehicle's original and replacement tires for any taxable year before the first taxable year in which the taxpayer used the original tire capitalization method. The procedures in section 7 of this revenue procedure apply for any taxable year before the first taxable year in which the taxpayer used the original tire capitalization method if the taxpayer's treatment of its qualifying vehicle's original tires or replacement tires is an issue under consideration in examination, before an area

appeals office, or before the Tax Court, or is an issue pending in examination, on April 3, 2002.

.06 *Changes Not Made under this Revenue Procedure.* A taxpayer that wants to change to the original tire capitalization method described in section 5 of this revenue procedure that does not change its method of accounting under section 6 or 7 of this revenue procedure must follow the change in method of accounting provisions in Rev. Proc. 2002–9 (or any successor). This change must be made with a § 481(a) adjustment.

SECTION 7. OPTIONAL SETTLEMENT FOR TAXPAYERS UNDER EXAMINATION, BEFORE AN AREA APPEALS OFFICE, OR BEFORE THE TAX COURT

.01 *In General.* If a taxpayer is within the scope of this revenue procedure, the treatment of the cost of its qualifying vehicles' original tires or replacement tires is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002–9) in examination, before an area appeals office, or before the Tax Court, or is an issue pending in examination (within the meaning of section 6.03(6) of Rev. Proc. 2002–9), on April 3, 2002, and the taxpayer does not change to the original tire capitalization method under section 6.03 of this revenue procedure, the Service offers to settle the original and replacement tires issue by changing the taxpayer's method of accounting for the cost of original and replacement tires to the original tire capitalization method in the earliest open taxable year after which there is no closed taxable year.

.02 *Terms of Settlement.*

(1) The Service will change the taxpayer's method of accounting for the cost of original and replacement tires to the original tire capitalization method described in section 5 of this revenue procedure.

(2) The change to the original tire capitalization method will be made using a cut-off method in the earliest open taxable year after which there is no closed taxable year.

(3) The taxpayer must reflect the settlement on its federal income tax returns for any affected succeeding taxable years. For example, an amount required to be capitalized during a taxable year covered by the settlement should be depreciated in that taxable year and in affected succeeding taxable years (whether or not covered by the settlement) in accordance with the taxpayer's method of accounting for depreciation.

(4) The Service will not require the taxpayer to change its method of accounting for the cost of its qualifying vehicles' original and replacement tires to a method other than the original tire capitalization method for any taxable year for which a federal income tax return has been filed as of the date of the closing agreement or other appropriate settlement agreement, provided that:

(a) the taxpayer has complied with all the applicable provisions of the closing agreement or other appropriate settlement agreement;

(b) there has been no taxpayer fraud, malfeasance, or misrepresentation of a material fact;

(c) there has been no change in the material facts on which the closing agreement or other appropriate settlement agreement was based; and

(d) there has been no change in the applicable law on which the closing agreement or other appropriate settlement agreement was based.

(5) The taxpayer must execute a closing agreement under § 7121 or other appropriate settlement agreement as described in section 7.05 of this revenue procedure.

.03 *Procedures for Requesting the Settlement.*

(1) *Initiating the request.*

(a) *Taxable years under examination or in Appeals.* A taxpayer that wants to request a settlement under this section for taxable years under examination or in Appeals must submit its request in writing to the first line examination manager or appeals officer (whichever is applicable) on or before September 3, 2002.

(b) *Taxable years before the Tax Court.* A taxpayer that wants to request a settlement under this section for taxable years before the Tax Court must submit its request in writing to the Chief Counsel attorney assigned to the case on or before the earlier of September 3, 2002, or the date that is 30 days before the date the case is first set for trial, which is the date scheduled for the calendar call.

(2) *Statement of facts, law, and arguments.* The request for settlement must include the following information:

(a) the taxpayer's name, address, telephone number, and taxpayer identification number;

(b) the taxable years covered by the proposed settlement;

(c) the taxpayer's earliest open taxable year after which there is no closed taxable year;

(d) the taxpayer's current method of accounting for the cost of its qualifying vehicles' original and replacement tires; and

(e) a statement of the material facts, including the capitalized amount and the deductible amount computed under the original tire capitalization method for each taxable year under examination, before an area appeals office, or before the Tax Court, and an explanation of the computations used to determine those amounts.

(3) *Perjury statement.* The request for settlement must be accompanied by the following declaration: "Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete." This declaration must be signed by, or on behalf of, the taxpayer by an individual with the authority to bind the taxpayer in these matters. The declaration may not be signed by the taxpayer's representative.

.04 *Procedures for Processing the Request.*

(1) *Receipt of request acknowledged.* The first line examination manager, appeals officer, or Chief Counsel attorney (whichever is applicable) will acknowledge receipt of the taxpayer's request for settlement in writing within 15 business days of receipt.

(2) *Factual development.* The first line examination manager, appeals officer, or Chief Counsel attorney (whichever is applicable) will contact the taxpayer to discuss any questions the Service may have, or ask for additional information believed to be necessary to execute the settlement (for example, to verify the correctness of the taxpayer's information).

(3) *Acceptance*. The first line examination manager, appeals officer, or Chief Counsel attorney (whichever is applicable) will accept the taxpayer's request for settlement if the request complies with the applicable terms of this revenue procedure. For taxable years before the Tax Court, the settlement is subject to the approval of the Court.

(4) *Notification of acceptance*. The first line examination manager, appeals officer, or Chief Counsel attorney (whichever is applicable) will notify the taxpayer in writing when the Service agrees to the settlement requested by the taxpayer.

.05 *Procedures for Implementing the Settlement*.

(1) *Closing agreement or other appropriate settlement agreement required*. A taxpayer implementing a settlement is required to execute a closing agreement under § 7121 or other appropriate settlement agreement.

(2) *Contents of closing agreement or other appropriate settlement*. A closing agreement must comply with the requirements of Rev. Proc. 68–16 (1968–1 C.B. 770) and must be substantially in the form set forth in the APPENDIX of this revenue procedure. Settlement agreements in cases pending before the Tax Court must conform substantially to the provisions set forth in the APPENDIX of this revenue procedure and must conform to the rules and procedures of the Tax Court.

(3) *Review and execution of closing agreement or other appropriate settlement*.

(a) *Taxpayers under examination*. The first line examination manager will prepare a closing agreement. The first line examination manager should submit the closing agreement to the appropriate Territory Manager (LMSB) or Territory Manager, Compliance (SB/SE) (whichever is applicable) and his or her assigned counsel for review prior to submitting the closing agreement to the taxpayer for execution. Failure by the examination manager to submit the closing agreement to the Territory Manager or his or her assigned counsel for review will not invalidate the closing agreement. After the closing agreement has been executed by the taxpayer, it will be executed on behalf of the Service by the appropriate Director, Field Operations (LMSB) or Area Director, Field Compliance (SB/SE) (whichever is applicable).

(b) *Taxpayers before an area appeals office*. The appeals officer or appeals team case leader will prepare a closing agreement. After the closing agreement has been executed by the taxpayer, it will be executed on behalf of the Service by an authorized official from Appeals.

(c) *Taxpayers before the Tax Court*. For docketed taxable years before the Tax Court, the taxpayer and the Chief Counsel attorney must prepare an appropriate settlement document, settlement stipulation, or stipulated decision document, pursuant to the rules and procedures of the court. The settlement document, settlement stipulation, or stipulated decision document is subject to the approval of the court.

(4) *Amended returns*.

(a) *In general*. In cases pending before examination or appeals, the Service will make the adjustments necessary to reflect the settlement to the taxpayer's returns for the taxable years under examination or before an area appeals office. In cases pending before the Tax Court, the settlement agreement will include adjustments necessary to reflect the settlement with respect to the year(s) before the court. The taxpayer is required to file amended returns to reflect the settlement for any other affected taxable years for which a federal income tax return has been filed as of the date of the closing agreement or other appropriate settlement agreement. The amended returns must include the adjustments to taxable income necessary to reflect the new method and any collateral adjustments to taxable income or tax liability resulting from the change. A taxpayer eligible to file a qualified amended return under Rev. Proc. 94–69 (1994–2 C.B. 804) may satisfy the requirements of this section by filing a qualified amended return in accordance with that revenue procedure.

(b) *Time and manner*. The taxpayer must file any required amended returns prior to the date it executes the closing agreement or other appropriate settlement agreement. The taxpayer must provide a copy of the amended returns to the first line examination manager, appeals officer, or Chief Counsel attorney (whichever is applicable) before the closing agreement or other appropriate settlement agreement is executed.

.06 *Effect on Other Offices of the Service*. If a taxpayer is before an area appeals office or the Tax Court regarding the treatment of the cost of its qualifying vehicles' original and replacement tires and does not settle this issue under the provisions of this section 7, an appropriate representative from an area appeals office or Chief Counsel office may settle a particular taxpayer's case involving this issue on a more favorable or less favorable basis than provided in this revenue procedure. For example, an appeals officer may settle a case based on the hazards of litigation.

SECTION 8. EFFECTIVE DATE

01. *In general*. This revenue procedure is effective for taxable years ending on or after December 31, 2001.

02. *Form 3115 pending with the Service*. If a taxpayer filed a Form 3115 with the national office to make the change in method of accounting authorized by this revenue procedure, and this Form 3115 is pending with the national office on April 3, 2002, the taxpayer may make the change under this revenue procedure. However, the national office will process the Form 3115 in accordance with the authority under which it was filed unless the taxpayer notifies the national office by July 2, 2002, that it intends to make the method change under this revenue procedure. If the taxpayer timely notifies the national office that it wants to make the method change under this revenue procedure, any user fee submitted with the Form 3115 will be returned to the taxpayer.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified and amplified to include this accounting method change in section 2 of the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue procedure is Mark Pitzer of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Charlotte Chyr at (202) 622–3110 (not a toll-free call).

APPENDIX

Department of the Treasury Internal Revenue Service

Closing Agreement on Final Determination Covering Specific Matters

Under § 7121 of the Internal Revenue Code, [*insert taxpayer's name, address, telephone number, and identifying number*] ("the taxpayer") and the Commissioner of Internal Revenue ("the Commissioner") make the following closing agreement:

WHEREAS:

1. The accounting method issue covered by this closing agreement is the taxpayer's method of accounting for the cost of its qualifying vehicles' original and replacement tires. The definitions of qualifying vehicle, original tires, and replacement tires set forth in section 3 of Rev. Proc. 2002–27, apply for purposes of this closing agreement.

2. The taxable year(s) covered by this closing agreement are [*insert applicable taxable year(s) covered by the agreement*].

3. Under the taxpayer's present method of accounting for the cost of its qualifying vehicles' original and replacement tires, the taxpayer [*describe in detail the taxpayer's current method of accounting being changed: for example, "deducts the cost of its qualifying vehicles' original and replacement tires when purchased"*].

4. The taxpayer and the Commissioner relied on the following facts and representations in making this closing agreement: [*insert relevant facts, including the amounts capitalized or deducted under the original tire capitalization method for each taxable year under examination, before an area appeals office, or before the Tax Court, an explanation of the computations used to determine those amounts, and a statement of whether the amounts capitalized or deducted for each of those taxable years is taken into account for federal income tax purposes*].

5. [*If applicable, insert:*] The taxpayer has filed an amended return(s) for the taxable year(s) ended [*insert applicable affected succeeding taxable year(s) for which a federal income tax return has been filed as of the date of the closing agreement*] to reflect the change in method of accounting for the cost of the qualifying vehicles' original and replacement tires described in this closing agreement.

6. [*If applicable, insert:*] A stipulated decision has been entered by the [*insert name of federal court*] with respect to the taxable year(s) ended [*insert date(s)*] that reflects taxable income for such year(s) computed using the original tire capitalization method described in section 5 of Rev. Proc. 2002–27 for the cost of the qualifying vehicles' original and replacement tires.

NOW IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes:

1. That the Service is changing the taxpayer's method of accounting for the cost of its qualifying vehicles' original and replacement tires to the original tire capitalization method of accounting described in section 5 of Rev. Proc. 2002–27, for the taxable year ended [*insert earliest open taxable year after which there is no closed taxable year*].

2. That the change in method of accounting is to be made on a cut-off basis.

3. That the adjustment(s) to tax attributable to the adjustment(s) to taxable income resulting from the change in the method of accounting for the cost of the qualifying vehicles' original and replacement tires (including the current year adjustment(s) and any collateral adjustments to taxable income or tax liability resulting from the change) for each taxable year covered by the closing agreement are as follows: [*insert the adjustments to each taxable year covered by the closing agreement in table form*].

4. That the change in method of accounting for the cost of the qualifying vehicles' original and replacement tires is a change in method of accounting within the meaning of Rev. Proc. 2002–27. As such, the provisions of § 446 and the regulations thereunder apply to the original tire capitalization method of accounting described in section 5 of Rev. Proc. 2002–27 for the cost of the qualifying vehicles' original and replacement tires.

5. That, under section 7.02(4) of Rev. Proc. 2002–27, the Service will not require the taxpayer to change its method of accounting for the cost of its qualifying vehicles' original and replacement tires to a method other than the original tire capitalization method for [*insert taxable year(s) for which a federal income tax return has been filed as of the date of this closing agreement*], provided that: (a) the taxpayer has complied with all the applicable provisions of this closing agreement; (b) there has been no taxpayer fraud, malfeasance, or misrepresentation of a material fact; (c) there has been no change in the material facts on which this closing agreement was based; and (d) there has been no change in the applicable law on which this closing agreement was based.

6. That the Service is not precluded from challenging the computation of the amounts capitalized or deducted for any taxable year covered by this closing agreement on a basis unrelated to the original tire capitalization method (for example, that all or a portion of the cost of a qualifying vehicle's original or replacement tires is not incurred under § 461).

7. [*If applicable, insert:*] That the following additional conditions also apply: [*insert, for example, conditions with respect to waiving restrictions on assessment and collection, paying any tax, abating any overassessment, or refunding or crediting any tax overpayment*].

8. That the taxpayer accepts this settlement and agrees to the applicable terms of Rev. Proc. 2002–27.

This agreement is final and conclusive except:

(1) The matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of a material fact;

(2) It is subject to the Internal Revenue Code sections that expressly provide that effect be given to their provisions (including any stated exception for § 7122) notwithstanding any law or rule of law; and

(3) If it relates to a tax period ending after the date of this agreement, it is subject to any law enacted after the agreement date, that applies to the tax period.

By signing, the parties certify that they have read and agreed to the terms of this document.

Taxpayer (other than individual):

By: ____________________ Date:____________________
Title:____________________

Commissioner of Internal Revenue:

By:____________________ Date:____________________
Title:____________________

Instructions

This agreement must be signed and filed in triplicate. (All copies must have original signatures.) The original and copies of the agreement must be identical. The name of the taxpayer must be stated accurately. The agreement may relate to one or more years.

If an attorney or agent signs the agreement for the taxpayer, the power of attorney (or a copy) authorizing that person to sign must be attached to the agreement.

If the taxpayer is a corporation, the agreement must be dated and signed with the name of the corporation, the signature and title of an authorized officer or officers, or the signature of an authorized attorney or agent. It is not necessary that a copy of an enabling corporate resolution be attached.

Use additional pages if necessary and identify them as part of this agreement.

Please see Rev. Proc. 68–16 (1968–1 C.B. 770) for a detailed description of practices and procedures applicable to most closing agreements.

Part IV. Items of General Interest

Electronic Submission of Form 8850

Announcement 2002–44

Form 8850

Employers submit Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits*, to State Employment Security Agencies (SESAs) as part of the process of obtaining those tax credits. The Internal Revenue Service will allow the electronic submission of Forms 8850 with SESAs that choose to establish a system to electronically receive this form. In general, the electronic system must meet the requirements described in paragraphs (1) through (6) below.

For purposes of this announcement, "employer" refers to an employer required to submit a Form 8850 or an authorized employer representative.

Requirements

(1) *In General*. The electronic system must ensure that the information received is the information sent, and it must document all occasions of access that result in the submission of a Form 8850. In addition, the design and operation of the electronic system, including access procedures, must make it reasonably certain that the persons signing the Form 8850, accessing the system, and submitting the Form 8850 are the job applicant and employer identified in the form.

(2) *Same Information as Paper Form 8850*. The electronic submission must provide the SESA with exactly the same information as the paper Form 8850.

(3) *Jurat and Signature Requirements*. The electronic submission must be signed by the job applicant and the employer under penalties of perjury.

(A) *Jurat*. The jurats (perjury statements) must contain the language that appears on the paper Form 8850 for the job applicant and the employer, respectively. The electronic system must inform the job applicant and the employer that they must make the declaration contained in the applicable jurat and that the declaration is made by signing the Form 8850. The instructions and the language of each jurat must immediately follow the information provided by the job applicant or the employer, as applicable, and must immediately precede that person's electronic signature.

(B) *Electronic Signatures*. The electronic signatures must (1) identify the job applicant whose name is on the electronic Form 8850 and the employer submitting the electronic Form 8850, and (2) authenticate and verify the submission. For this purpose, the terms "authenticate" and "verify" have the same meaning as they do when applied to a written signature on a paper Form 8850. An electronic signature can be in any form that satisfies the foregoing requirements. The electronic signature of the employer must be the final entry in the submission.

(4) *Copies of Electronic Form 8850*. The electronic system must enable the employer to supply and, upon request by the Internal Revenue Service, the employer must supply (A) a hard copy of the electronic Form 8850 submitted to the SESA and (B) a statement that, to the best of the employer's knowledge, the electronic Form 8850 was submitted by the employer with respect to the named job applicant. The hard copy of the electronic Form 8850 must provide exactly the same information as, but need not be a facsimile of, the paper Form 8850.

(5) *Retention of Forms 8850 by the SESAs and Employers*. Electronic Forms 8850 have the same status as paper Forms 8850. Therefore, guidance that applies to paper Forms 8850 also applies to electronic Forms 8850. For example, as is the case for paper Forms 8850, electronic Forms 8850 are required to be retained by employers under their established recordkeeping systems. For further information, see Rev. Proc. 98–25 (1998–1 C.B. 689) (information regarding the retention of records within an Automatic Data Processing System).

Drafting Information

The principal author of this announcement is Robert Wheeler. For further information regarding this announcement, contact Karin Loverud at (202) 622–6080 (not a toll-free call).

IRS Issues Document Warning Taxpayers to be Aware of Home-Based Business Tax Avoidance Schemes

Announcement 2002–48

The Internal Revenue Service just released a new brochure entitled *Home-Based Business Tax Avoidance Schemes . . .At A Glance*. The schemes described in the document claim to offer tax "relief," but actually result in illegal tax avoidance.

The promoters of these schemes claim that by setting up a bogus home-based business, individual taxpayers can deduct most, or all, of their personal expenses as business expenses. The brochure includes some examples of personal expenses that are not deductible but are commonly claimed as business expenses in home-based business tax avoidance schemes.

The brochure explains that no matter how convincing the claims that are found in marketing materials for these schemes may appear, nondeductible personal living expenses cannot be transformed into deductible business expenses. The tax code firmly establishes that a clear business purpose and profit motive must exist in order to generate and claim allowable business expenses.

Taxpayers who claimed such deductions on a past tax return should file an amended return as soon as possible to limit possible interest and penalties on top of any taxes they might owe.

To find out more about home-based business tax avoidance schemes, order IRS Document 01300 (02–2002) by calling 1–800–829–2437, or visit *www.irs.gov*.

Notice of Disposition of Declaratory Judgment Proceedings Under Section 7428

This announcement serves notice to donors that on January 14, 2002, the United States Tax Court entered a Decision accepting the agreement of the parties regarding the organization described below. The organization listed below is recognized as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) for taxable years prior to January 1, 2001. Pursuant to the Decision, the organization listed below is not recognized as an organization described in section 501(c)(3) and is not exempt from tax under section 501(a) for taxable years beginning January 1, 2001.

Living Truth Ministries
Austin, TX

This announcement serves notice to donors that on February 15, 2002, the United States Tax Court entered a decision accepting the agreement of the parties that the organization listed below is not recognized as an organization described in section 501(c) and is not exempt from taxation under section 501(a), effective October 1, 1996.

Endowment for Paso Del Norte
Schools, Inc.
El Paso, TX

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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Ann. 2002–14, 2002–7 I.R.B. *540*

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Bulletin No. 2002–18
May 6, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–23, page 811.
The Service will accept, as timely filed, a federal tax return, claim for refund, statement, or other document required or permitted to be filed with the Service that is mailed from and officially postmarked in a foreign country on or before the last date prescribed for filing, including any extension of time for filing. This ruling also sets forth the position that a federal return, claim for refund, statement, or other document required or permitted to be filed with the Service or with the United States Tax Court given to a designated international private delivery service before midnight on the last date prescribed for filing shall be deemed timely filed pursuant to section 7502 of the Code. Rev. Rul. 80–218 superseded.

Rev. Proc. 2002–28, page 815.
Methods of accounting; inventories; small business taxpayers. This procedure provides that the Commissioner will exercise his discretion to except qualifying small business taxpayers from the requirements to use an accrual method of accounting under section 446 of the Code and to account for inventories under section 471 of the Code. Rev. Proc. 2002–9 modified and amplified. Notice 2002–14 modified and superseded.

EMPLOYEE PLANS

Notice 2002–27, page 814.
Minimum distributions; reporting requirements. This notice provides guidance on the reporting required from issuers, custodians, and trustees with respect to required minimum distributions from individual retirement arrangements (IRAs).

Announcement 2002–46, page 834.
Safe harbor explanation (in Spanish); certain qualified plan distributions. This announcement repeats, in Spanish, the safe harbor explanation to employees portion of Notice 2002–3 (2002–2 I.R.B. 289) that plan administrators may use for recipients of eligible rollover distributions in order to satisfy section 402(f) of the Code.

EXEMPT ORGANIZATIONS

Announcement 2002–47, page 844.
This document solicits comments addressing whether several regulations under Chapter 42 should be revised, with respect to excise taxes imposed on foundation and organization managers, to conform to recently-issued final regulations under section 4958 of the Code. This announcement also solicits comments addressing any other areas of Chapter 42 regulations that may need updating.

Announcement 2002–50, page 845.
A list is provided of organizations now classified as private foundations.

(Continued on the next page)

Finding Lists begin on page ii.
Index for January through April begins on page v.

Department of the Treasury
Internal Revenue Service

EXCISE TAX

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This document solicits comments addressing whether several regulations under Chapter 42 should be revised, with respect to excise taxes imposed on foundation and organization managers, to conform to recently-issued final regulations under section 4958 of the Code. This announcement also solicits comments addressing any other areas of Chapter 42 regulations that may need updating.

ADMINISTRATIVE

REG–104762–00, page 825.
Proposed regulations under section 6331 of the Code provide for the prohibition of levy while an installment agreement is pending with the Secretary, while an installment agreement is in effect, and following the rejection or termination of an installment agreement. The regulations clarify when levy is prohibited and the effect of that prohibition on the statute of limitations for collection. They also provide that the IRS may not commence a proceeding in court for the collection of a tax included in a proposed or active installment agreement while levy is prohibited by this section.

REG–105369–00, page 828.
Proposed regulations under sections 148 and 141 of the Code provide guidance on the definitions of investment-type property and private loan for the arbitrage and private activity restrictions applicable to tax-exempt bonds issued by state and local governments. A public hearing is scheduled for September 24, 2002. REG–113526–98 withdrawn.

Announcement 2002–45, page 833.
Methods of accounting; small business taxpayers. This announcement discusses some of the most significant issues raised in comments received in response to Notice 2001–76 (2001–52 I.R.B. 613). The notice proposed procedures under which qualifying small business taxpayers with average annual gross receipts of $10,000,000 or less would be excepted from the requirements to use an accrual method of accounting under section 446 of the Code and to account for inventories under section 471 of the Code for eligible businesses.

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Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 162.—Trade or Business Expenses

26 CFR 1.162–1: Cost of materials.

Qualifying small business taxpayers with average annual gross receipts of $10,000,000 or less are excepted from the requirement to account for inventories under § 471 for eligible trades or businesses, but may account for inventoriable items as materials and supplies that are not incidental under § 1.162–3. See Rev. Proc. 2002–28, page 815.

Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A–1: Uniform capitalization of costs.

For eligible trades or businesses, inventoriable items of qualifying small business taxpayers with average annual gross receipts of $10,000,000 or less are not subject to § 263A, but may be treated as materials and supplies that are not incidental under § 1.162–3. See Rev. Proc. 2002–28, page 815.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

Qualifying small business taxpayers with average annual gross receipts of $10,000,000 or less are excepted from the requirements to use an accrual method of accounting under § 446 and to account for inventories under § 471 for eligible trades or businesses. See Rev. Proc. 2002–28, page 815.

Section 447.—Method of Accounting for Corporations Engaged in Farming

Taxpayers that are required to use the accrual method of accounting under § 447 are not "qualifying small business taxpayers" that are excepted from the requirements to use an accrual method of accounting under § 446 and to account for inventories under § 471. See Rev. Proc. 2002–28, page 815.

Section 448.—Limitation on Use of Cash Method of Accounting

26 CFR 1.448–1T: Limitations on the use of the cash receipts and disbursements method of accounting.

Taxpayers that are required to use the accrual method of accounting under § 448 are not "qualifying small business taxpayers" that are excepted from the requirements to use an accrual method of accounting under § 446 and to account for inventories under § 471. See Rev. Proc. 2002–28, page 815.

Section 460.—Special Rules for Long-Term Contracts

26 CFR 1.460–1: Long-term contracts.

Under § 460, qualifying small business taxpayers with average annual gross receipts of $10,000,000 or less that are excepted from the requirements to use an accrual method of accounting under § 446 and to account for inventories under § 471 for eligible trades or businesses may be required to account for certain items using a long-term contract method. See Rev. Proc. 2002–28, page 815.

Section 471.—General Rule for Inventories

26 CFR 1.471–1: Need for inventories.

Qualifying small business taxpayers with average annual gross receipts of $10,000,000 or less are excepted from the requirements to use an accrual method of accounting under § 446 and to account for inventories under § 471 for eligible trades or businesses, and may account for inventoriable items as materials and supplies that are not incidental under § 1.162–3. See Rev. Proc. 2002–28, page 815.

Section 481.—Adjustments Required for Changes in Method of Accounting

26 CFR 1.481–1: Adjustments in general.
26 CFR 1.481–4: Adjustments taken into account with consent.

For eligible trades or businesses, qualifying small business taxpayers with average annual gross receipts of $10,000,000 or less may obtain automatic consent to change to the cash receipts and disbursements method of accounting and to account for inventoriable items as materials and supplies that are not incidental under § 1.162–3. See Rev. Proc. 2002–28, page 815.

Section 1001.—Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001–1: Computation of gain or loss.

Notwithstanding § 1001 and the regulations thereunder, qualifying small business taxpayers that are excepted from the requirements to use an accrual method of accounting under § 446 of the Code and to account for inventories under § 471 for eligible trades or businesses will include amounts attributable to open accounts receivable (due in 120 days or less) in income as the amounts are actually or constructively received. See Rev. Proc. 2002–28, page 815.

Section 6081.—Extension of Time for Filing Returns

Section 7502.—Timely Mailing Treated as Timely Filing and Paying

26 CFR § 1.6081–1(a): Extension of time for filing returns.
26 CFR 301.7502–1: Timely mailing treated as timely filing.

This ruling sets forth the position that the Internal Revenue Service will accept, as timely filed, a federal tax return, claim for refund, statement, or other document required or permitted to be filed with the Service that is mailed from and officially postmarked in a foreign country on or before the last date prescribed for filing,

including any extension of time for filing. The ruling also sets forth the position that a federal tax return, claim for refund, statement, or other document required or permitted to be filed with the Service or with the United States Tax Court given to a designated private delivery service before midnight on the last date prescribed for filing shall be deemed timely filed pursuant to sections 7502(a), (d)(1), and (f)(1) of the Code.

Rev. Rul. 2002–23

ISSUES:

1. Whether the Internal Revenue Service ("Service") will accept as timely filed a federal tax return, claim for refund, statement, or other document required or permitted to be filed with the Service when it is mailed from and officially postmarked in a foreign country on or before the last date prescribed for filing?

2. Whether a federal tax return, claim for refund, statement, or other document required or permitted to be filed with the Service or with the United States Tax Court is timely filed when it is given to a designated delivery service in a foreign country and recorded or marked as described in section 7502(f)(2)(C) before midnight on the last date prescribed for filing?

LAW AND ANALYSIS:

Pursuant to Rev. Rul. 80–218 (1980–2 C.B. 386), and Policy Statement P–2–9 (July 27, 1969), the Service has accepted federal tax returns mailed by taxpayers from foreign countries as timely filed if they bear an official postmark dated on or before the last date prescribed for filing, including any extension of time for such filing. If the last date for filing falls on a Saturday, Sunday, or a legal holiday within the meaning of section 7503, returns have been considered timely if postmarked on or before the next succeeding day which is not a Saturday, Sunday, or a legal holiday. This revenue ruling reaffirms the position previously announced in Rev. Rul. 80–218 and Policy Statement P–2–9. For purposes of this revenue ruling, the term legal holiday means a legal holiday in the District of Columbia in the United States, or a Statewide legal holiday in the State where the federal tax return, claim for refund or other document is required to be filed or sent. The term does not include legal holidays in foreign countries unless such holidays are also legal holidays in the District of Columbia or applicable State, as described above.

In addition, pursuant to the authority granted by section 6081(a) of the Code, which permits the Commissioner to grant a reasonable extension of time for filing any return, declaration, statement or other document, this revenue ruling expands the application of the timely mailing is timely filing rules set forth in Rev. Rul. 80–218 to claims for refund, statements or other documents required or permitted to be filed with the Service. Accordingly, claims for refund, statements and other documents will be treated as timely filed if the conditions described above are satisfied. If, however, the envelope that contains a claim, statement or other document has a timely postmark, but it is received after the time when an envelope postmarked and mailed at that time and location would ordinarily be received, the sender may be required to prove that it was timely mailed.

Timely filing treatment, however, will not apply to foreign postmarked documents filed with the United States Tax Court, such as petitions and notices of appeal, unless given to a designated international delivery service as discussed below. *See, e.g., Sarrell v. Commissioner*, 117 T.C. 122 (2001).

Section 7502(f) authorizes the Secretary to designate delivery services satisfying the requirements of section 7502(f)(2) to deliver items qualifying for timely mailing as timely filing treatment in the same manner as items postmarked and deposited in the United States mail. Returns, claims for refund, statements and other documents sent via an international delivery service qualify for timely mailing as timely filing treatment if the international delivery service meets the requirements of section 7502(f)(2) and is designated under Rev. Proc. 97–19 (1997–1 C.B. 644). Accordingly, returns, claims for refund, statements and other documents given to a designated international delivery service before midnight on the last date prescribed for filing with the Service will be deemed timely filed on the date the document was given to the delivery service, as recorded electronically on its data base or marked on the cover in which the item is to be delivered, as described in section 7502(f)(2)(C). If the last date for filing falls on a Saturday, Sunday, or a legal holiday within the meaning of section 7503, returns, claims, statements and other documents will be considered timely if given to a designated international delivery service before midnight on the next succeeding day which is not a Saturday, Sunday, or a legal holiday. Timely filing treatment will also apply to documents filed with the United States Tax Court, such as petitions or notices of appeal, pursuant to section 7502(d)(1).

HOLDINGS:

1. The Internal Revenue Service will accept, as timely filed, a federal tax return, claim for refund, statement, or other document required or permitted to be filed with the Service that is mailed from and officially postmarked in a foreign country on or before the last date prescribed for filing, including any extension of time for filing. If the last date for filing falls on a Saturday, Sunday, or a legal holiday within the meaning of section 7503, returns, claims, statements, and other documents will be considered timely if postmarked on or before the next succeeding day which is not a Saturday, Sunday, or a legal holiday.

2. A federal tax return, claim for refund, statement, or other document required or permitted to be filed with the Service or with the United States Tax Court that is given to a designated international delivery service before midnight on the last date prescribed for filing shall be deemed timely filed pursuant to section 7502(a), (d)(1), and (f)(1). If the last date for filing falls on a Saturday, Sunday, or a legal holiday within the meaning of section 7503, returns, claims, statements, and other documents will be considered timely if given to a designated international delivery service before midnight on the next succeeding day which is not a Saturday, Sunday, or a legal holiday. Such returns, claims for refund, statements, or other documents will be deemed filed on the date the document was given to the designated delivery service, as recorded electronically on its data base or marked on the cover in which the item is to be delivered pursuant to section 7502(f)(2)(C).

EFFECT ON OTHER REVENUE RULINGS:

Rev. Rul. 80–218 (1980–2 C.B. 386) is superseded.

DRAFTING INFORMATION

The principal author of this revenue ruling is David A. Abernathy of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact Mr. Abernathy at (202) 622–7860 (not a toll-free call).

Reporting Required Minimum Distributions From IRAs

Notice 2002–27

PURPOSE

This notice provides guidance on the reports that trustees, custodians, and issuers are required to make with respect to required minimum distributions from individual retirement accounts and annuities (IRAs).

BACKGROUND

Section 401(a)(9)(A) of the Internal Revenue Code provides rules for required minimum distributions from qualified plans during the life of an employee and § 401(a)(9)(B) provides rules for required minimum distributions after the death of an employee. Section 408(a)(6) and (b)(3) provides that rules similar to the rules of § 401(a)(9) apply to IRA distributions. Under § 401(a)(9)(C), the required beginning date for an IRA owner is April 1 of the calendar year following the calendar year in which the owner attains age 70½.

Section 408(i) provides that the trustee of an IRA shall make reports regarding such accounts as the Secretary may require.

Proposed regulations under §§ 401 (a)(9) and 408(a)(6) and (b)(3) were published in January 2001 (REG–130477–00; REG–130481–00, 2001–1 C.B. 865). The proposed regulations, which substantially simplified the rules for determining required minimum distributions, provided that the trustee, custodian, or issuer of an IRA is required to report the amount of required minimum distributions from an IRA in accordance with IRS forms and instructions. For purposes of this notice, the term "trustee" includes a trustee, custodian, and an issuer of IRAs. The preamble to the proposed regulations described a process under which the IRS would be receiving public comments and consulting with interested parties in order to evaluate how to implement a reporting requirement that would provide the most useful information to the IRA owners and beneficiaries while minimizing the burden on IRA trustees.

The IRS has received a number of comments regarding the reporting requirement in the proposed regulations and the comments have been taken into account. Final and temporary regulations under §§ 401(a)(9) and 408(a)(6) and (b)(3) were published at 67 F.R. 18988 (Apr. 17, 2002). These regulations are effective January 1, 2003.

Section 1.408–8, Q&A–10, of the new regulations provides that the trustee of an IRA is required to report information, with respect to the amount required to be distributed from the IRA for each calendar year, to individuals or entities, at the time, and in the manner, prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin as well as in federal tax forms and accompanying instructions. This notice is being issued in conjunction with those regulations and pursuant to this delegation of authority to require reporting with respect to required minimum distributions from IRAs.

The reporting provisions in this notice are intended to assist taxpayers in complying with the minimum distribution requirement. However, the Treasury and the IRS continue to have concerns about the overall level of compliance in this area and intend to monitor the effect of the new reporting regime on compliance to determine whether it would be appropriate to modify the regime in the future.

Although reporting of a required minimum distribution applies with respect to each IRA, the IRA owner may take the required minimum distribution from another IRA of the owner to the extent permitted under Q&A–9 of § 1.408–8.

REPORTING

I. Required Reporting to the IRA Owner

If a minimum distribution is required with respect to an IRA for a calendar year and the IRA owner is alive at the beginning of the year, the trustee that held the IRA as of December 31 of the prior year must provide a statement to the IRA owner by January 31 of the calendar year regarding the required minimum distribution in accordance with either of the two alternatives in this section. This requirement is effective beginning with required minimum distributions for 2003 (so that the first reports are due January 31, 2003).

Alternative one. An IRA trustee furnishes the IRA owner with a statement of the amount of the required minimum distribution with respect to the IRA for the calendar year and the date by which such amount must be distributed. The amount is permitted to be calculated assuming that the sole beneficiary of the IRA is not a spouse more than 10 years younger than the IRA owner and that no amounts received by the IRA after December 31 of the prior year are required to be taken into account to adjust the value of the IRA as of December 31 of the prior year for purposes of determining the required minimum distribution pursuant to Q&A–7 or Q&A–8 of § 1.408–8.

Alternative two. An IRA trustee provides a statement to the IRA owner that: (1) informs the IRA owner that a minimum distribution with respect to the IRA is required for the calendar year and the date by which such amount must be distributed and (2) includes an offer to furnish the IRA owner, upon request, with a calculation of the amount of the required minimum distribution with respect to the IRA for that calendar year. If the IRA owner requests such a calculation, the IRA trustee must calculate the required minimum distribution for the IRA owner and report that amount to the IRA owner.

Under both alternatives, the statement must also inform the IRA owner that the trustee will be reporting to the IRS, beginning with required minimum distributions for calendar year 2004, that the IRA owner is required to receive a required minimum distribution for the calendar year. (See section II below.) The statement can be provided to the IRA owner in conjunction with the statement of the fair market value of the IRA as of December 31 of the prior year that is otherwise required to be provided to the IRA owner by January 31 of a year.

If the surviving spouse of a deceased IRA owner elects to treat an IRA for which the spouse is the sole beneficiary as the spouse's own IRA by redesignating the IRA as an account in the name of the

spouse as IRA owner rather than as beneficiary, the IRA trustee reports information on the required minimum distribution to the surviving spouse under the IRA owner rules in this section I. If the spouse is the sole beneficiary of an IRA of a deceased owner but has not affirmatively redesignated the IRA as the spouse's own IRA, the IRA trustee is permitted to assume that the surviving spouse of the deceased IRA owner has not elected to treat the IRA as the spouse's own IRA and continues to be treated as a beneficiary for purposes of § 401(a)(9).

II. Required Reporting to the IRS

Beginning with required minimum distributions for calendar year 2004, if a minimum distribution is required with respect to an IRA for a calendar year, the trustee of the IRA must indicate that a minimum distribution is required with respect to the IRA for the calendar year (but need not indicate the amount) on Form 5498, *Individual Retirement Arrangement Information,* for the immediately preceding year (*i.e.*, on a 2003 Form 5498 for a 2004 required minimum distribution) in accordance with the instructions for Form 5498.

III. No Reporting for Section 403(b) Contracts and IRAs of Deceased Owners

Section 1.403(b)–3 provides that a section 403(b) contract is treated as an individual retirement plan for purposes of satisfying the required minimum distribution rules. Consequently, the delegation of authority to require reporting for IRAs also applies to section 403(b) contracts. However, no reporting is required at this time with respect to required minimum distributions from section 403(b) contracts.

Reporting is also not required at this time with respect to IRAs of deceased owners. Accordingly, no reporting is required for Roth IRAs because there are no lifetime minimum distributions required for Roth IRAs. If reporting is required in the future for section 403(b) contracts or IRAs of deceased owners, the IRS will issue additional guidance, which will be effective prospectively.

IV. Application for Years After 2003

This notice provides the reporting rules for required minimum distributions for calendar year 2003. For required minimum distributions for calendar years after 2003, these rules apply except to the extent modified in federal tax forms and accompanying instructions.

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. section 3507) under control number 1545–1779.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information in this notice is in the section titled "REPORTING." This information is required to inform IRA owners of their required minimum distributions for the year. The likely respondents are (1) businesses or other for-profit institutions and (2) not-for-profit institutions.

The estimated total annual reporting burden is 1,170,000 hours.

The estimated annual burden per respondent varies from 4 minutes to 20 hours, depending on individual circumstances, with an estimated average of 15 hours. The estimated number of respondents is 78,000.

The estimated annual frequency of responses is one.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

DRAFTING INFORMATION

The principal authors of this notice are Steven Linder of the Employee Plans, Tax Exempt and Government Entities Division and Cathy Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday by calling 1–877–829–5500 (a toll-free number). Mr. Linder can be reached at (202) 283–9888 (not a toll-free number). Ms. Vohs can be reached at (202) 622–6090 (not a toll-free number).

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26 CFR 601.204: Changes in accounting periods and methods of accounting.
(Also Part I §§, 162, 263A, 446, 447, 448, 460, 471, 481, 1001; 1.162–3, 1.263A–1, 1.446–1, 1.448–1T, 1.460–1, 1.471–1, 1.481–1, 1.481–4, 1.1001–1.)

Rev. Proc. 2002–28

SECTION 1. PURPOSE

In order to reduce the administrative and tax compliance burdens on certain small business taxpayers and to minimize disputes between the Internal Revenue Service and small business taxpayers regarding the requirement to use an accrual method of accounting (accrual method) under § 446 of the Internal Revenue Code because of the requirement to account for inventories under § 471, this revenue procedure provides that the Commissioner of Internal Revenue will exercise his discretion to except a qualifying small business taxpayer (as defined in section 5.01 of this revenue procedure) from the requirements to use an accrual method of accounting under § 446 and to account for inventories under § 471. This revenue procedure also provides the procedures by which a qualifying small business taxpayer may obtain automatic consent to change to the cash receipts and disbursements method of accounting (cash method) and/or to a method of accounting for inventoriable items as materials and supplies that are not incidental under § 1.162–3 of the Income Tax Regulations.

SECTION 2. BACKGROUND

.01 Section 446(a) provides that taxable income must be determined under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books.

.02 Section 446(c) generally allows a taxpayer to select the method of accounting it will use to compute its taxable income. A taxpayer is entitled to adopt

any one of the permissible methods for each separate trade or business, including the cash method or an accrual method, subject to certain restrictions. For example, § 446(b) provides that the selected method must clearly reflect income. In addition, § 1.446–1(c)(2)(i) requires that a taxpayer use an accrual method with regard to purchases and sales of merchandise whenever § 471 requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under § 1.446–1(c)(2)(ii). Under § 1.446–1(c)(2)(ii), the Commissioner has the authority to permit a taxpayer to use a method of accounting that clearly reflects income even though the method is not specifically authorized by the regulations.

.03 Section 447 generally requires the taxable income from farming of a C corporation engaged in the trade or business of farming, or a partnership engaged in the trade or business of farming with a C corporation partner, to be determined using an accrual method, unless the C corporation meets the $1,000,000 ($25,000,000 for family corporations) gross receipts test.

.04 Section 448 generally prohibits the use of the cash method by a C corporation (other than a farming business and a qualified personal service corporation) and a partnership with a C corporation partner (other than a farming business and a qualified personal service corporation), unless the C corporation or partnership with a C corporation partner meets a $5,000,000 gross receipts test. Section 448 also prohibits tax shelters from using the cash method.

.05 The cash method generally requires an item of income to be included in income when actually or constructively received and permits a deduction for an expense when paid. Section 1.446–1(c)(1)(i). Other provisions of the Code or regulations applicable to cash method taxpayers may change these general rules, including, for example, § 263 (requiring the capitalization of expenses paid out for a new building or for permanent improvements or betterments made to increase the value of any property or estate, or for restoring property or making good the exhaustion of property for which an allowance is or has been made); § 263A (requiring capitalization of direct and allocable indirect costs of real or tangible personal property produced by a taxpayer or real or personal property that is acquired by a taxpayer for resale); § 460 (requiring the use of the percentage-of-completion method for certain long-term contracts); and § 475 (requiring dealers in securities to mark securities to market).

.06 Section 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary to clearly determine the income of the taxpayer, inventories must be taken by the taxpayer. Section 1.471–1 generally requires a taxpayer to account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.

.07 Section 1.162–3 requires taxpayers carrying materials and supplies (other than incidental materials and supplies) on hand to deduct the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the taxable year. In the case of incidental materials and supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, taxpayers may include in their expenses and deduct from gross income the total cost of such incidental supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

.08 Section 263A generally requires direct costs and an allocable portion of indirect costs of certain property produced or acquired for resale by a taxpayer to be included in inventory costs, in the case of property that is inventory, or to be capitalized, in the case of other property. However, resellers with gross receipts of $10,000,000 or less are not required to capitalize costs under § 263A, and certain producers with $200,000 or less of indirect costs are not required to capitalize certain costs under § 263A. See §§ 263A(b)(2)(B) and 1.263A–2(b)(3)(iv).

.09 Sections 446(e) and 1.446–1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e).

.10 Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is determined under a method of accounting different from the method used to determine taxable income for the preceding taxable year.

SECTION 3. SCOPE

.01 *Applicability*. This revenue procedure applies to a qualifying small business taxpayer as defined in section 5.01.

.02 *Taxpayers Not within the Scope of this Revenue Procedure*.

Notwithstanding section 3.01 of this revenue procedure, this revenue procedure does not apply to a farming business (within the meaning of § 263A(e)(4)) of a qualifying small business taxpayer. If a qualifying small business taxpayer is engaged in the trade or business of farming, this revenue procedure may apply to the taxpayer's non-farming trades or businesses, if any. A taxpayer engaged in the trade or business of farming generally is allowed to use the cash method for any farming business, unless the taxpayer is required to use an accrual method under § 447 or is prohibited from using the cash method under § 448.

SECTION 4. QUALIFYING SMALL BUSINESS TAXPAYER EXCEPTION

.01 Pursuant to his discretion under §§ 446 and 471, and to simplify the recordkeeping requirements of a qualifying small business taxpayer, the Commissioner, as a matter of administrative convenience, will allow a qualifying small business taxpayer to use the cash method as described in this revenue procedure for a trade or business described in this section 4.01 (eligible trade or business).

(1) A qualifying small business taxpayer may use the cash method as described in this revenue procedure for all of its trades or businesses if the taxpayer satisfies any one of the following three tests and did not previously change (and was not previously required to have changed) from the cash method to an accrual method for any trade or business

as a result of becoming ineligible to use the cash method under this revenue procedure.

(a) The taxpayer reasonably determines that its principal business activity (as defined in section 5.04, below) is described in a North American Industry Classification System ("NAICS") code other than one of the ineligible codes listed below. The ineligible NAICS codes are as follows:

(i) mining activities within the meaning of NAICS codes 211 and 212;

(ii) manufacturing within the meaning of NAICS codes 31–33;

(iii) wholesale trade within the meaning of NAICS code 42;

(iv) retail trade within the meaning of NAICS codes 44 and 45; and,

(v) information industries within the meaning of NAICS codes 5111 and 5122.

Information regarding the NAICS codes can be found at *www.census.gov.* Visitors to the site should select "Subjects A to Z," followed by "N," and then should select "North American Industry Classification System." Taxpayers also may find a partial list of NAICS codes, described as "Principal Business Activity Codes," in the instructions to their tax return forms.

(b) Notwithstanding that a taxpayer's principal business activity is described in one of the ineligible NAICS codes listed above in section 4.01(1)(a), the taxpayer reasonably determines that its principal business activity is the provision of services, including the provision of property incident to those services.

(c) Notwithstanding that a taxpayer's principal business activity is described in one of the ineligible NAICS codes listed above in section 4.01(1)(a), the taxpayer reasonably determines that its principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications. For purposes of this rule, tangible personal property is not fabricated or modified in accordance with customer design or specifications if the customer merely chooses among pre-selected options (such as size, color, or materials) offered by the taxpayer or if the taxpayer must make only minor modifications to its basic design to meet the customer's specifications. Moreover, a taxpayer that manufacturers an item in quantities for a customer is not treated as fabricating or modifying tangible personal property in accordance with customer design or specifications.

(2) Under current law, a taxpayer with two or more trades or businesses that has a trade or business that is permitted to use the cash method may use such method for such trade or business. Therefore, notwithstanding that a taxpayer's principal business activity is not described above in section 4.01(1) and thus the taxpayer can not use the cash method for all of its trades or businesses, a taxpayer may use the cash method with respect to any separate and distinct trade or business if the principal business activity of the trade or business is not described in an ineligible NAICS code in section 4.01(1)(a)(i) through (v) or is described in either section 4.01(1)(b) or section 4.01(1)(c). No trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business. See § 1.446–1(d)(2).

.02 A taxpayer who satisfies the qualifying small business taxpayer exception described in section 4.01 and chooses not to use an overall accrual method with inventories being accounted for under § 471 has the following three options for an eligible trade or business under this revenue procedure:

(1) The taxpayer can use the overall cash method and account for inventories under § 471;

(2) The taxpayer can use an overall accrual method and account for inventoriable items, as defined in section 5.09 below, in the same manner as materials and supplies that are not incidental under § 1.162–3 (see sections 4.04 and 4.05 below); or

(3) The taxpayer can use the overall cash method and account for inventoriable items in the same manner as materials and supplies that are not incidental under § 1.162–3 (see sections 4.04 and 4.05 below).

.03 Notwithstanding § 1001 and the regulations thereunder, qualifying small business taxpayers that use the cash method for an eligible trade or business under section 4.01 of this revenue procedure shall include amounts attributable to "open accounts receivable" (as defined in section 5.10) in income as such amounts are actually or constructively received. However, § 1001 may be applicable to other transactions.

.04 Qualifying small business taxpayers that are permitted to use the cash method for an eligible trade or business under section 4.01 of this revenue procedure and that do not want to account for inventories under § 471 must treat all inventoriable items in such trade or business in the same manner as materials and supplies that are not incidental under § 1.162–3. For purposes of this revenue procedure, taxpayers are not required to apply § 263A to inventoriable items that are treated as materials and supplies that are not incidental. Items that would be accounted for as incidental materials and supplies for purposes of § 1.162–3 may still be accounted for in that manner. Whether an item is purchased for resale or use (and thus accounted for as a non-incidental material and supply) or is purchased to provide to customers incident to services (and thus may be accounted for as either an incidental or a non-incidental material and supply depending on the facts and circumstances) must be determined under general tax principles.

.05 Under § 1.162–3, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer's business. For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year the qualifying small business taxpayer provides the items to a customer. Thus, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the goods, whichever is later. A qualifying small business taxpayer may determine the amount of the allowable deduction for non-incidental materials and supplies by using either a specific identification method, a first in, first out (FIFO) method, or an average cost method, provided that method is used consistently. See § 1.471–2(d). A taxpayer may not use the last in, first out (LIFO) method described in § 472 and the regulations thereunder to determine the amount of the allowable deduction for non-incidental materials and supplies.

.06 The method of accounting used by a qualifying small business taxpayer for financial accounting ("book") purposes will not affect the taxpayer's eligibility under this revenue procedure to use the cash method or the method of accounting for inventoriable items as non-incidental materials and supplies under § 1.162–3. However, taxpayers must still comply with the requirements under § 446(a) and the regulations thereunder to maintain adequate books and records, which may include a reconciliation of any differences between such books and records and their return. See § 1.446–1(a)(4).

SECTION 5. DEFINITIONS

.01 *Qualifying Small Business Taxpayer*. A qualifying small business taxpayer is any taxpayer with "average annual gross receipts" of $10,000,000 or less that is not prohibited from using the cash method under § 448.

.02 *Average Annual Gross Receipts*. A taxpayer has average annual gross receipts of $10,000,000 or less if, for each prior taxable year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the three taxable-year period ending with the applicable prior taxable year do not exceed $10,000,000. If a taxpayer has not been in existence for three prior taxable years, the taxpayer must determine its average annual gross receipts for the number of years (including short taxable years) that the taxpayer has been in existence. See § 448(c)(3)(A).

.03 *Business Activity*. A taxpayer may use any reasonable method of applying the relevant facts and circumstances to determine what is a business activity. For example, for some taxpayers, the provision of services, the sale of goods, and the production of goods each will be treated as a different business activity. However, if a taxpayer sells or produces goods incident to the performance of services, the different activities may be treated as one business activity—the provision of services.

.04 *Principal Business Activity*. A principal business activity is determined by the sources of gross receipts. Under sections 4.01(1)(a), (b), and (c), a taxpayer must apply the tests in this section to all the taxpayer's trades or businesses in the aggregate. Under section 4.01(2), a taxpayer must apply the tests in such section separately to each trade or business for which the taxpayer keeps a complete and separable set of books and records. A taxpayer may use either of the following tests to determine the principal business activity of the taxpayer or of the taxpayer's trades or businesses.

(1) *Principal business activity prior year test*. Under the principal business activity prior year test, the principal business activity is the activity from which the largest percentage of gross receipts was derived during the prior taxable year (even if this amount is less than 50 percent of the aggregate gross receipts of the taxpayer or the trade or business). If a taxpayer or a trade or business is in its first taxable year, the principal business activity is the activity from which the largest percentage of gross receipts is derived for that taxable year.

(2) *Principal business activity three-year average test*. Under the principal business activity three-year average test, the principal business activity is the activity from which the largest percentage of average annual gross receipts was derived over the three taxable-year period ending with the prior taxable year. If a taxpayer or a trade or business has not been in existence for three prior taxable years, the taxpayer must determine average annual gross receipts for the number of years (including short taxable years) that the taxpayer or the trade or business has been in existence. See § 448(c)(3)(A).

.05 *Gross Receipts*. Gross receipts is defined consistent with § 1.448–1T(f)(2)(iv) of the Temporary Income Tax Regulations. Thus, gross receipts for a taxable year equal all receipts that must be recognized under the method of accounting actually used by the taxpayer for that taxable year for federal income tax purposes. For example, gross receipts include total sales (net of returns and allowances), all amounts received from services, interest, dividends, and rents. However, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. See also § 448(c)(3)(C).

.06 *Aggregation of Gross Receipts*. For purposes of computing gross receipts under section 5.02, all taxpayers treated as a single employer under subsection (a) or (b) of § 52 or subsection (m) or (o) of § 414 (or that would be treated as a single employer under these sections if the taxpayers had employees) will be treated as a single taxpayer. However, when transactions occur between taxpayers that are treated as a single taxpayer by the previous sentence, gross receipts arising from these transactions will not be treated as gross receipts for purposes of the average annual gross receipts limitation. See §§ 448(c)(2) and 1.448–1T(f)(2)(ii).

.07 *Treatment of Short Taxable Years*. In the case of a short taxable year, a taxpayer's gross receipts must be annualized by multiplying the gross receipts for the short taxable year by 12 and then dividing the result by the number of months in the short taxable year. See §§ 448(c)(3)(B) and 1.448–1T(f)(2)(iii).

.08 *Treatment of Predecessors*. Any reference to a taxpayer in this section 5 includes a reference to any predecessor of that taxpayer. See § 448(c)(3)(D).

.09 *Inventoriable Item Defined*. An inventoriable item is any item either purchased for resale to customers or used as a raw material in producing finished goods.

.10 *Open Accounts Receivable Defined*. For purposes of this revenue procedure, open accounts receivable is defined as any receivable due in full in 120 days or less.

SECTION 6. EXAMPLES

For purposes of the following examples, assume that:

(1) the taxpayers use the calendar year;

(2) the taxpayers are not prohibited from using the cash method under § 448 (except *Example 4*); and

(3) the taxpayers satisfy the average annual gross receipts test of section 5.02 of this revenue procedure (except *Examples 2* and *3*).

Example 1—Principal Business Activity Not an Ineligible NAICS Code. Taxpayer is a graphic design firm. Taxpayer plans, designs, and manages the production of visual communications that convey specific messages or concepts. Taxpayer's activities include the design of

printed materials, packaging, advertising, signage systems, and corporate identification (logos). Taxpayer reasonably determines that its principal business activity is described in NAICS code 541430 (graphic design services), which is not one of the ineligible NAICS codes listed in section 4.01(1)(a)(i)–(v) of this revenue procedure. Taxpayer may use the cash method for its graphic design business.

Example 2—Satisfaction of the Average Annual Gross Receipts Test. Taxpayer is a plumbing contractor that installs plumbing fixtures in customers' homes and businesses. Taxpayer reasonably determines that its principal business activity is construction, which is described in NAICS code 23. Taxpayer's gross receipts at the end of the three preceding taxable years are:

	Gross receipts
1998:	$ 6,000,000
1999:	9,000,000
2000:	12,000,000

Taxpayer's average annual gross receipts for the three taxable-year period ending in the 2000 taxable year are $9,000,000 (($6,000,000 + $9,000,000 + $12,000,000) / 3 = $9,000,000). Taxpayer may use the cash method for all its trades or businesses pursuant to this revenue procedure for its 2001 taxable year because its average annual gross receipts for each prior taxable year ending on or after December 31, 2000, is $10,000,000 or less and its principal business activity is not described in the ineligible NAICS codes listed in section 4.01(1)(a)(i)–(v).

Example 3—Failure of the Average Annual Gross Receipts Test. Same as *Example 2*, except that Taxpayer's gross receipts in 2001 equal $15,000,000. Taxpayer's average annual gross receipts for the three taxable-year period ending in the 2001 taxable year are $12,000,000 (($9,000,000 + $12,000,000 + $15,000,000/3) = $12,000,000). Taxpayer is not a qualifying small business taxpayer for purposes of this revenue procedure for its 2002 taxable year or any subsequent year because its average annual gross receipts for each prior taxable year ending on or after December 31, 2000, is not $10,000,000 or less.

Example 4—Inability to Use this Revenue Procedure When § 448 Applies. Same as *Example 2*, except that Taxpayer is a C corporation. Because Taxpayer's average annual gross receipts for the previous three years ($9,000,000) exceed $5,000,000, Taxpayer is prohibited from using the cash method under § 448. Consequently, Taxpayer is not eligible to use the cash method under this revenue procedure. The same result would apply under § 448 if, instead of being a C corporation, Taxpayer were a tax shelter (regardless of Taxpayer's average annual gross receipts) or Taxpayer were a partnership with a C corporation as a partner.

Example 5—Principal Business Activity Prior Year Test. Taxpayer is a plumbing contractor that installs plumbing fixtures in customers' homes and businesses. Taxpayer also has a store that sells plumbing equipment to homeowners and other plumbers who visit the store. During its prior taxable year, Taxpayer derived 60 percent of its total receipts from plumbing installation (including amounts charged for parts and fixtures used in installation) and 40 percent of its total receipts from the sale of plumbing equipment through its store. Under the principal business activity prior year test, Taxpayer reasonably determines that its principal business activity is plumbing installation, which is a construction activity described in NAICS code 23. Because Taxpayer's principal business activity—plumbing installation—is not described in the ineligible NAICS codes listed in section 4.01(1)(a)(i)–(v), Taxpayer may use the cash method for both business activities (plumbing installation and retail sales).

Example 6—Principal Business Activity Three-Year Average Test. Same as *Example 5*, except that for the prior taxable year, Taxpayer derived 40 percent of its total receipts from plumbing installation (including amounts charged for parts and fixtures used in installation) and 60 percent of its total receipts from the sale of plumbing equipment through its store. Under the principal business activity prior year test, Taxpayer's principal business activity is retail, which is described in an ineligible NAICS code. Thus, Taxpayer is not eligible to use the cash method for all of its trades or businesses under the principal business activity prior year test. However, Taxpayer may still be eligible to use the cash method for all of its trades or businesses under section 4.01(1) of this revenue procedure if Taxpayer reasonably determines that its principal business activity is plumbing installation under the principal business activity three-year average test. Taxpayer's gross receipts for the prior three taxable years are as follows:

	2000	*1999*	*1998*	*3 Year Average*
Plumbing installation	$2,000,000	$6,000,000	$4,000,000	$4,000,000
Retail sale of equipment	$3,000,000	$2,000,000	$4,000,000	$3,000,000
Total	$5,000,000	$8,000,000	$8,000,000	$7,000,000

The approximate percentage of Taxpayer's average annual gross receipts for the prior three taxable years is 57 percent ($4,000,000/$7,000,000 total average gross receipts) for plumbing installation and 43 percent ($3,000,000/$7,000,000) for the retail sale of plumbing equipment through its store. Thus, Taxpayer reasonably determines that its principal business activity is plumbing installation under the principal business activity three-year average test. Because Taxpayer's principal business activity—plumbing installation—is not described in the ineligible NAICS codes listed in section 4.01(1)(a)(i)-(v), Taxpayer may use the cash method for both business activities (plumbing and retail sales).

Example 7—Application of Section 4.01(2) Where Taxpayer Is Ineligible to Use the Cash Method Under Section

4.01(1). Same as *Examples 5* and *6*, except that Taxpayer's principal business activity is retail sales under both the principal business activity prior year test and the principal business activity three-year average test. Taxpayer is not eligible to use the cash method for all of its trades or businesses under section 4.01(1) because Taxpayer's principal business activity (retail sales) is described in an ineligible NAICS code under section 4.01(1)(a)(iv) and is neither the provision of services under section 4.01(1)(b) nor the fabrication or modification of tangible personal property under section 4.01(1)(c). Taxpayer, however, maintains its retail sales and plumbing installation activities as separate and distinct businesses with a complete and separable set of books and records for each business. Under section 4.01(2) of the revenue procedure, Taxpayer may use the cash method for its separate plumbing installation business notwithstanding that its principal business activity (retail sales) is ineligible under section 4.01(1)(a)–(c).

Example 8—A Principal Business Activity Can Account for Less Than 50 Percent of Gross Receipts. Taxpayer has four activities, Activities A through D. During the prior taxable year, Taxpayer derived 35 percent of its gross receipts from Activity A, 25 percent from Activity B, 20 percent from Activity C, and 20 percent from Activity D. Under the principal business activity prior year test, Activity A would be Taxpayer's principal business activity because it represents the largest percentage of gross receipts. Similarly, if the percentages of Taxpayer's average annual gross receipts for the prior three taxable years were 35 percent from Activity A, 25 percent from Activity B, 20 percent from Activity C, and 20 percent from Activity D, under the principal business activity three-year average test, Activity A would be Taxpayer's principal business activity because it represents the largest percentage of average annual gross receipts.

Example 9—Taxpayer Does Not Satisfy the NAICS Code Exception in Section 4.01(1)(a), the Service Exception in Section 4.01(1)(b), or the Custom Manufacturing Exception in Section 4.01(1)(c). Taxpayer sells refrigerators. As part of the sale price, Taxpayer delivers the refrigerator to the customer and confirms that the refrigerator is functioning properly at the customer's site. Taxpayer's principal business activity is described in the ineligible NAICS code 44. Moreover, Taxpayer's principal business activity is not the provision of services under section 4.01(1)(b). Taxpayer does not provide refrigerators incident to the performance of services. Rather, Taxpayer performs certain services (delivery and confirmation of functionality) incident to the sale of refrigerators. In addition, Taxpayer does not fabricate or modify tangible personal property under section 4.01(1)(c). Taxpayer may not use the cash method under this revenue procedure.

Example 10—Taxpayer Does Not Satisfy the NAICS Code Exception in Section 4.01(1)(a), the Service Exception in Section 4.01(1)(b), or the Custom Manufacturing Exception in Section 4.01(1)(c). Taxpayer is a sofa manufacturer that only produces sofas upon receipt of a customer order. Customers are allowed to pick among 150 different fabrics offered by the Taxpayer or to provide their own fabric, which the Taxpayer will use to finish the customer's sofa. Taxpayer's principal business activity is described in the ineligible NAICS code 33. Taxpayer does not provide sofas incident to the performance of services for purposes of section 4.01(1)(b). Rather, Taxpayer performs certain services (upholstering) incident to the sale of sofas. Taxpayer also does not fabricate or modify tangible personal property for purposes of section 4.01(1)(c) because customers merely choose among pre-selected options offered by Taxpayer and Taxpayer only makes minor modifications to the basic design of its sofa. Taxpayer may not use the cash method under this revenue procedure.

Example 11—Taxpayer Does Not Satisfy the NAICS Code Exception in Section 4.01(1)(a), the Service Exception in Section 4.01(1)(b) or the Custom Manufacturing Exception in Section 4.01(1)(c). Taxpayer is a publisher who produces and sells high school and college yearbooks. Taxpayer's principal business activity is described in the ineligible NAICS code 5111 (newspaper, periodical, book, and database publishers). Taxpayer is not providing a service for purposes of section 4.01(1)(b) because Taxpayer's principal business activity is the production of yearbooks for customers. In addition, Taxpayer is not a custom manufacturer for purposes of section 4.01(1)(c) because Taxpayer, although it produces yearbooks to the detailed specifications of schools, is producing yearbooks in quantities. As such, Taxpayer may not use the cash method under this revenue procedure.

Example 12—Taxpayer Creating Prototype Does Not Satisfy the NAICS Code Exception in Section 4.01(1)(a) but Does Satisfy the Custom Manufacturing Exception in Section 4.01(1)(c). Taxpayer makes tools based entirely on specific designs and specifications provided to it by customers. Taxpayer produces the customer's prototype and gives the prototype to the customer for production. Taxpayer's principal business activity is described in the ineligible NAICS code 33. However, Taxpayer's principal business activity is the fabrication of tangible personal property upon demand in accordance with customer design or specifications for purposes of section 4.01(1)(c). Taxpayer may use the cash method under this revenue procedure (subject to the potential application of § 460).

Example 13—Taxpayer Producing Quantities of Prototype Does Not Satisfy the Custom Manufacturing Exception in Section 4.01(1)(c). Same as *Example 12*, except that instead of producing the customer's prototype and giving the prototype to the customer for further production, Taxpayer is also the producer of the customer's goods using the prototype. Taxpayer's principal business activity would not fall under the custom manufacturer exception of section 4.01(1)(c).

Example 14—Application of Accounts Receivable 120–Day Rule in Section 4.03. Taxpayer is eligible to use the cash method under this revenue procedure. Taxpayer chooses to use the cash method and to account for inventoriable items as non-incidental materials and supplies under § 1.162–3. In December 2001, Taxpayer transfers property to a customer in exchange for an open accounts receivable (due in full in 120 days or less). In February 2002, the customer satisfies the accounts receivable when it pays cash to Taxpayer. As provided by section 4.03 of this revenue procedure, Taxpayer would not include any amount attributable to the accounts receivable in income in 2001. Rather, Taxpayer would include the full

amount of the accounts receivable in income in 2002 when it actually receives the cash payment from the customer.

Example 15—Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162–3—Construction. Taxpayer is a roofing contractor that is eligible to use the cash method under this revenue procedure. Taxpayer chooses to use the cash method and to account for inventoriable items as non-incidental materials and supplies under § 1.162–3. Taxpayer enters into a contract with a homeowner in December 2001 to replace the homeowner's roof. Taxpayer purchases roofing shingles from a local supplier and has them delivered to the homeowner's residence. Taxpayer pays the supplier $5,000 for the shingles upon their delivery later that month. Taxpayer replaces the homeowner's roof in December 2001, and gives the homeowner a bill for $15,000 at that time. Taxpayer receives a check from the homeowner in January 2002. The shingles are non-incidental materials and supplies. The cost of the shingles is deductible in the year Taxpayer uses and consumes the shingles or actually pays for the shingles, whichever is later. In this case, Taxpayer both pays for the shingles and uses the shingles (by providing the shingles to the customer in connection with the performance of roofing services) in 2001. Thus, Taxpayer deducts the $5,000 cost of the shingles on its 2001 federal income tax return. Taxpayer includes the $15,000 in income in 2002 when it receives the check from the homeowner.

Example 16—Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162–3—Construction. Same as in *Example 15*, except that Taxpayer does not replace the roof until January 2002 and is not paid until March 2002. Because the shingles are not used until 2002, their cost can only be deducted on Taxpayer's 2002 federal income tax return notwithstanding that Taxpayer paid for the shingles in 2001. Thus, on its 2002 return, Taxpayer must report $15,000 of income and $5,000 of deductions.

Example 17—Timing of Deduction for Non-Inventoriable Items—Speculative Home Sales. Taxpayer is eligible to use the cash method as described in this revenue procedure. Taxpayer is a speculative builder of houses that are built on land it owns. In 2001, Taxpayer builds a house using various items such as lumber, piping, and metal fixtures that it had paid for in 2000. In 2002, Taxpayer sells the house to a buyer. Because the house is real property held for sale by Taxpayer, the house and the material used to build the house are not inventoriable items under this revenue procedure. Thus, Taxpayer may not account for the items used to build the house as non-incidental materials and supplies under § 1.162–3. Rather, Taxpayer must capitalize the costs of the lumber, piping, metal fixtures and other goods used by Taxpayer to build the house under § 263. Upon the sale of the house in 2002, the costs capitalized by Taxpayer will be offset against the house sales price to determine Taxpayer's gain or loss from the sale.

Example 18—Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162–3—Construction. Same as in *Example 17*, except that (1) Taxpayer builds houses on land its customers own, and (2) the houses are built in three months with payment due at completion. Because Taxpayer does not own the house, the lumber, piping, metal fixtures and other goods used by Taxpayer in the provision of construction services are inventoriable items, not real property held for sale. Taxpayer elects to treat the goods used to build the house as non-incidental materials and supplies under § 1.162–3. Taxpayer must deduct the cost of the lumber, piping, metal fixtures and other non-incidental materials and supplies that are used by it to build the house in 2001 (the year those items were used by Taxpayer to build the house) notwithstanding that Taxpayer had paid for the items in 2000. Taxpayer will report income it receives from its customer as the income is actually or constructively received.

Example 19—Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162–3—Reseller. Taxpayer is a veterinarian that also sells pet supplies from its clinic. Taxpayer reasonably determines that its principal business activity is veterinary services, which is not described in one of the ineligible NAICS codes in section 4.01(1)(a)(i)–(v). Consequently, Taxpayer is eligible to use the cash method for all its business activities (veterinary services and retail sales). For both business activities, Taxpayer chooses to use the cash method and to account for inventoriable items (such as pet food) as non-incidental materials and supplies under § 1.162–3. In December of 2001, Taxpayer purchases and pays for pet food to be resold from its clinic. Taxpayer sells the pet food from its clinic (and receives cash payment from the customer) in 2002. Because the pet food is not provided to customers until 2002, its cost can not be deducted until 2002.

Example 20—Timing of Deduction for Inventoriable Items Treated as Non-Incidental Materials and Supplies Under § 1.162–3—Manufacturer. Taxpayer is a landscape designer that also manufactures lawn ornaments. Taxpayer does not manufacture lawn ornaments pursuant to customer contracts. Taxpayer reasonably determines that its principal business activity is landscape design, which is not described in an ineligible NAICS code under section 4.01(1)(a)(i)–(v). Consequently, Taxpayer is eligible to use the cash method for all its business activities (landscape design and lawn ornament manufacturing). For both business activities, Taxpayer chooses to use the cash method and to account for inventoriable items (such as raw materials) as non-incidental materials and supplies under § 1.162–3. In 2001, Taxpayer purchases and pays for raw materials to be used in its manufacturing business and uses the raw materials to produce lawn ornaments. During 2002, Taxpayer sells the lawn ornaments to customers. Because the lawn ornaments are not provided to customers until 2002, the cost of the raw materials used to produce the lawn ornaments can not be deducted until 2002.

Example 21—Application of Long Term Contract Rules—§ 460 Applicable. Taxpayer is a specialty tool and die manufacturer. Taxpayer receives a request from a large automobile manufacturer to design and produce a custom-made die that the customer will use in its manufacturing operation. The contract to manufacture the die is entered into in December 2001 but is not completed until May 2002. Because it satisfies the requirements of section 4.01(1)(c) of this

revenue procedure, Taxpayer is eligible to use the overall cash method of accounting. Notwithstanding the Taxpayer's eligibility to use the overall cash method, however, because the contract to manufacture the custom-made die requires the production of a "unique item" and will not be completed in the year it is entered into, it is a "long term contract" for purposes of § 460, and the income and expense relating to that contract must be accounted for under the percentage-of-completion method of accounting described in § 460 and the underlying regulations.

Example 22—Application of Long Term Contract Rules—§ 460 Not Applicable. Taxpayer is a residential home builder that specializes in modest single family homes whose construction period averages six months. Taxpayer uses an overall accrual method of accounting, and although it is not required to do so, Taxpayer has elected to use the percentage-of-completion method of accounting, as described in § 1.460–4(b), in accounting for its home construction activities. Because its principal business activity is not described in an ineligible NAICS code described in section 4.01(1)(a), Taxpayer may elect the overall cash method described in this revenue procedure. Further, because its home construction activity is not required to be accounted for using the percentage-of-completion method described in § 460, Taxpayer is eligible (but not required) to change its method of accounting for that activity to the cash method.

Example 23—Taxpayer Satisfies the NAICS Code Provision in Section 4.01(1)(a). Taxpayer is a licensed medical clinic that provides specialized chemotherapy treatment to cancer patients. The medication provided to patients accounts for 26 percent of Taxpayer's average annual gross receipts. Taxpayer does not sell the medications separately from its provision of services, selects the medications to be used in a particular session based on its own professional skill and judgment, and does not maintain medications for more than two weeks. Because the provision of medical services (NAICS code 62) represents Taxpayer's principal business activity, Taxpayer qualifies to use the cash method under section 4.01(1)(a) for all of its trades or businesses. Even if the cost of the chemotherapy medications represented Taxpayer's principal source of gross receipts, Taxpayer nonetheless would qualify to use the cash method under section 4.01(1)(a) of this revenue procedure, because its principal business activity would still be providing medical services, with goods being provided only incident to the provision of those services. See *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner,* 113 T.C. 376 (1999), *acq. in result* 2000–1 C.B. xvi.

Example 24—Change in Principal Business Activity. Taxpayer owns a hardware store and a small appliance repair business. Following the issuance of this revenue procedure, Taxpayer reasonably determined that its principal business activity was its appliance repair business, which is not described in an ineligible NAICS code under section 4.01(1)(a)(i)–(v). Consequently, Taxpayer was eligible to use the cash method under this revenue procedure for both its business activities (appliance repair and retail sales). Over time, Taxpayer's hardware store began to generate a larger portion of Taxpayer's gross receipts than its repair business. In 2005, Taxpayer's retail business became its principal business activity. Because retail trade is described in ineligible NAICS code 44, starting in 2006, Taxpayer is no longer eligible to use the cash method for all its trades or businesses under section 4.01(1). Accordingly, Taxpayer must change to an accrual method for its retail business. If Taxpayer maintains a complete and separable set of books and records in 2006 for its repair business, Taxpayer may continue to use the cash method for its repair business under section 4.01(2). If Taxpayer does not maintain a complete and separable set of books and records in 2006 for its repair business, Taxpayer also must change to an accrual method for its repair business —however, in any subsequent taxable year that Taxpayer maintains complete and separable books and records for its repair business, Taxpayer will be eligible under section 4.01(2) to change to the cash method for its repair business.

Example 25—Change in Principal Business Activity. Same as *Example 24*, except that Taxpayer's repair business again becomes its principal business activity in 2009. Taxpayer is no longer eligible to use the cash method for its retail business under section 4.01(1). For section 4.01(1) to apply, Taxpayer must not have previously changed (or have been previously required to change) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method under this revenue procedure. Because Taxpayer was required to change to an accrual method for its retail business in 2006 as a result of becoming ineligible to use the cash method under this revenue procedure, Taxpayer is not eligible to rely on section 4.01(1) for 2006 or any subsequent taxable year.

Example 26—Change in Principal Business Activity. Same as *Example 24*, except that following the issuance of this revenue procedure, Taxpayer's principal business activity was retail sales and Taxpayer used an accrual method for both businesses (retail and repair). Over time, Taxpayer's repair business began to generate a larger portion of Taxpayer's gross receipts than its retail business. In 2007, Taxpayer's repair business became its principal business activity. Starting in taxable year 2008, Taxpayer is eligible under section 4.01(1) to use the cash method for all its trades and businesses because Taxpayer did not change (and was not required to have changed) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method for that trade or business under this revenue procedure, and Taxpayer's principal business activity is no longer described in an ineligible NAICS code under section 4.01(1)(a)(i)–(v).

SECTION 7. CHANGE IN ACCOUNTING METHOD

.01 *In General*. Any change in a taxpayer's method of accounting pursuant to this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

.02 *Automatic Change for Taxpayers within the Scope of this Revenue Procedure*.

(1) *Automatic change to the cash method*. A qualifying small business taxpayer that wants to use the cash method as described in this revenue procedure for

an eligible trade or business must follow the automatic change in accounting method provisions of Rev. Proc. 2002–9 (2002–3 I.R.B. 327) (or its successor), as modified by Rev. Proc. 2002–19 (2002–13 I.R.B. 696), and Announcement 2002–17 (2002–8 I.R.B. 561), with the following modifications:

(a) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply. However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, see section 6.02(9) of Rev. Proc. 2002–9 for additional filing requirements.

(b) Taxpayers filing Form 3115, *Application for Change in Accounting Method*, for a change in method of accounting under this revenue procedure must complete all applicable parts of the form but need not complete Part II of Schedule A of Form 3115. Specifically, Part II of Form 3115, line 17 (regarding information on gross receipts in previous years) and Part III of Form 3115 (regarding the § 481(a) adjustment) must be completed. Taxpayers should write "Filed under Rev. Proc. 2002–28" at the top of their Form 3115.

(c) A taxpayer making a change under section 7.02 of this revenue procedure for its first taxable year ending on or after December 31, 2001, that, on or before May 6, 2002, files or filed its original federal income tax return for such year, is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002–9, provided the taxpayer complies with the following filing requirement. The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to the taxpayer's amended federal income tax return for the taxpayer's first taxable year ending on or after December 31, 2001. This amended return must be filed no later than September 16, 2002. A copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002–9 for the address) no later than when the taxpayer's amended return is filed.

(2) *Automatic change to § 1.162–3.* A qualifying small business taxpayer that does not want to account for inventories under § 471 must make any necessary change from the taxpayer's inventory method (and, if applicable, from the method of capitalizing costs under § 263A) to treat inventoriable items in the same manner as materials and supplies that are not incidental under § 1.162–3. For purposes of such a change, the rules of section 7.02(1) of this revenue procedure apply.

(3) *Other automatic changes.* An automatic change in method under this revenue procedure would also include any other change in method of accounting that is eligible to be made under this revenue procedure in conjunction with either or both of the above changes in this section 7.02 (such as a change from a long-term contract method that is not required to be used by § 460). For purposes of such a change, the rules of section 7.02(1) of this revenue procedure apply.

(4) *Single Form 3115.* Any combination of changes under this revenue procedure may be included in the same Form 3115 to be filed by the taxpayer.

.03 *Section 481(a) Adjustment.*

(1) *Determining the net amount.* The net amount of the § 481(a) adjustment computed under this revenue procedure must take into account both increases and decreases in the applicable account balances such as accounts receivable, accounts payable, and inventory. For example, the § 481(a) adjustment may include the difference resulting from changing from taking inventory accounts under § 471 to treating the inventoriable items as materials and supplies that are not incidental under § 1.162–3.

(2) *Multiple adjustments.* In the event that a taxpayer is taking into account a § 481(a) adjustment from another accounting method change in addition to the § 481(a) adjustment required by this revenue procedure, the § 481(a) adjustments would be taken into account separately. For example, a taxpayer that changed from the cash method to an accrual method in 1999 and was required to take its § 481(a) adjustment into account over four years would continue to take into account that adjustment over the appropriate four years even though the taxpayer changes back to the cash method in 2001 and has an additional § 481(a) adjustment required by this revenue procedure.

(3) *Section 481(a) adjustment period.* As provided in section 2 of Rev. Proc. 2002–19, the period for negative § 481(a) adjustments is one year, and the period for positive § 481(a) adjustments is four years.

.04 *Taxpayers Not within the Scope of this Revenue Procedure.*

(1) A taxpayer that ceases to qualify for the qualifying small business taxpayer exception described in section 4 of this revenue procedure for a trade or business and that otherwise is required to use an accrual method for that trade or business must change to an accrual method (and, if applicable an inventory method that complies with §§ 263A and 471) for that trade or business using either the automatic change in accounting method provisions of section 5.01 of the APPENDIX to Rev. Proc. 2002–9, if applicable, as modified by Rev. Proc. 2002–19 or the advance consent provisions of Rev. Proc. 97–27 (1997–1 C.B. 679) (or its successor), as modified by Rev. Proc. 2002–19.

(2) No inference is intended regarding whether a taxpayer that does not satisfy the qualifying small business taxpayer exception in section 4 is otherwise permitted to use the cash method. Taxpayers who do not qualify to change to the cash method under this revenue procedure may still request permission to change to the cash method under Rev. Proc. 97–27, as modified. See also Rev. Proc. 2001–10 (2001–1 C.B. 272).

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified and amplified to include this automatic change in sections 5 and 9 of the APPENDIX. Notice 2002–14 (2002–8 I.R.B. 548) is modified and superseded.

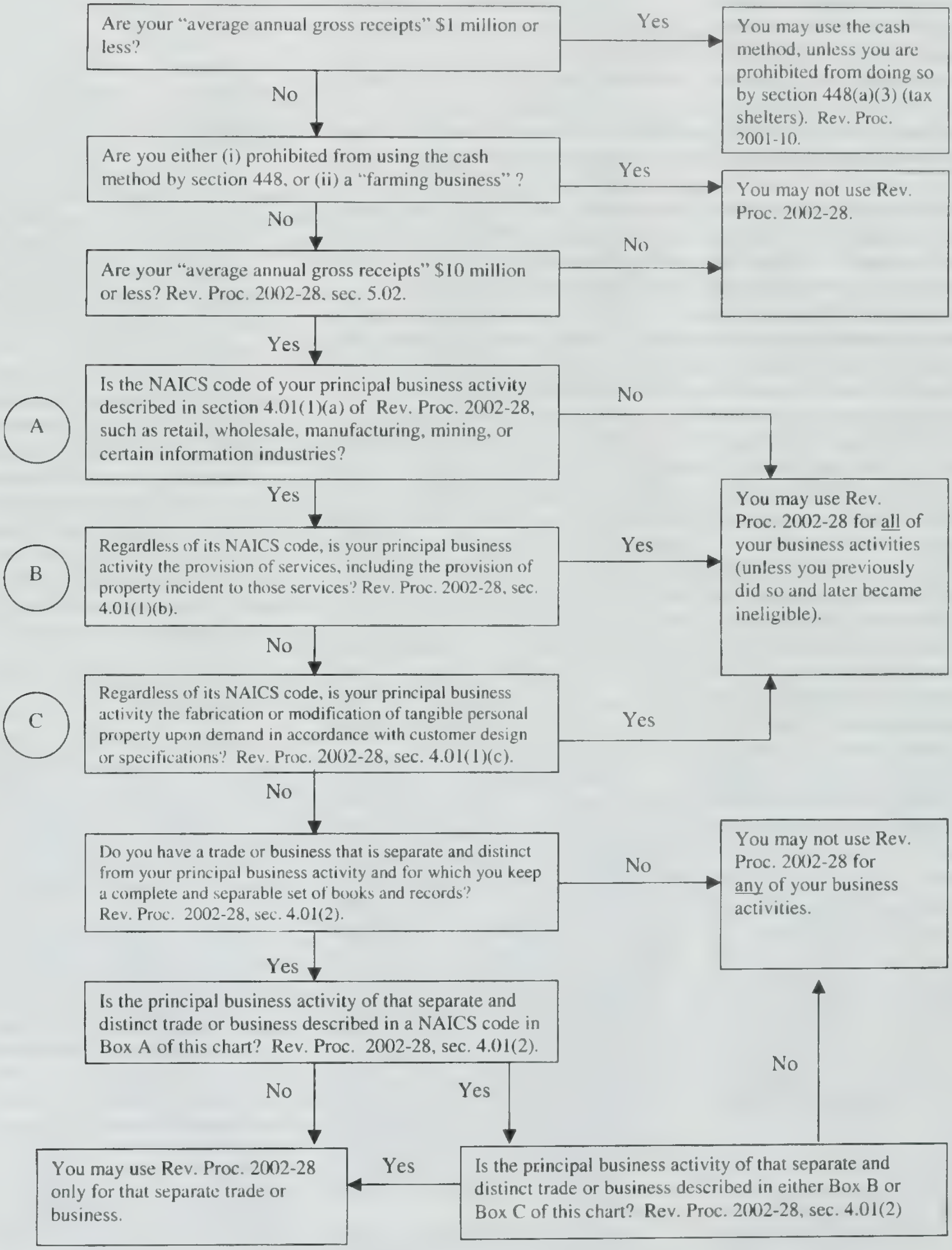
SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2001. However, the Service will not challenge a taxpayer's use of the cash method under § 446 or a taxpayer's failure to account for inventories under § 471 for a trade or business in an earlier year if the taxpayer, for that year, would have been a qualifying small business taxpayer as described in section 5.01 of this revenue procedure and would have been eligible to use the cash method in such year under section 4 of this revenue procedure if this revenue procedure had been applicable to that taxable year.

DRAFTING INFORMATION

The principal author of this revenue procedure is W. Thomas McElroy, Jr., of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. McElroy at (202) 622–4970 (not a toll-free call).

APPENDIX
APPLICATION OF REV. PROC. 2002–28



Part IV. Items of General Interest

Notice of Proposed Rulemaking

Levy Restrictions During Installment Agreements

REG–104762–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to restrictions on levy during the period that an installment agreement is proposed or in effect. The proposed regulations reflect changes to the law made by the Internal Revenue Service Restructuring and Reform Act of 1998.

DATE: Written or electronically generated comments and requests for a public hearing must be received by July 16, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–104762–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–104762–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at *www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Frederick W. Schindler, (202) 622–3620; concerning submissions of comments or requests for a hearing Treena Garret, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Procedure and Administration Regulations (26 CFR part 301) under section 6331 of the Internal Revenue Code (Code). The proposed regulations reflect the amendment of section 6331 by section 3462 of the Internal Revenue Service Restructuring and Reform Act of 1998 Public Law, 105–206, (112 Stat. 685, 764) (RRA 1998). New subsection 6331(k) codifies the IRS practice of withholding collection during consideration of a taxpayer's offer to compromise and extends that practice to proposed installment agreements. The proposed regulations deal principally with the effect of subsection 6331(k) when an installment agreement has been proposed and is pending, is in effect, or has been rejected or terminated.

Prior to the enactment of RRA 1998, the IRS had a long-standing practice of staying action to collect a liability while an offer to compromise that liability was being evaluated and considered, unless the interests of the United States would be jeopardized by doing so. See Policy Statement P–5–97 (Approved July 10, 1959), reprinted at IRM 1.5.17. To insure that the interests of the United States would not be jeopardized while collection was withheld, the IRS required that taxpayers execute a waiver of the statute of limitations for collection of the liabilities the taxpayer was attempting to compromise.

Section 3462 of RRA 1998 added subsection 6331(k) to the Code. Paragraph (1) of the new subsection codifies the IRS policy of withholding collection during the pendency of an offer to compromise by prohibiting levy while an offer to compromise is pending, for thirty days after a rejection, and during any appeal of that rejection. Temporary regulations (T.D. 8829, 1999–2 C.B. 235) published in the **Federal Register** on July 21, 1999, contained provisions governing the effects of subsection 6331(k) when taxpayers submit offers to compromise. See § 301.7122–1T.

Prior to RRA 1998, the IRS did not stay collection when a taxpayer submitted an offer of an installment agreement. Because installment agreements provide for the full payment of the tax liabilities at issue, the processing of requests for installment agreements is less formal and most requests were accepted or rejected within several days of receipt. Once an installment agreement took effect, regulations prohibited levy, as well as certain other enforced collection measures, unless the installment agreement provided otherwise. See § 301.6159–1(d).

Paragraph 6331(k)(2) prohibits levy while a taxpayer's proposal of an installment agreement is pending with the IRS, for thirty days after rejection of such a proposal, while an installment agreement is in effect, for thirty days after termination of an installment agreement by the IRS, and during a timely filed appeal by the taxpayer to the IRS Office of Appeals of a rejection or termination decision.

Paragraph 6331(k)(3) provides that "rules similar to" those contained in paragraphs (3), (4), and (5) of subsection 6331(i) shall apply generally for the purposes of subsection 6331(k). Subsection 6331(i) governs the prohibition on levy during the pendency of a proceeding for refund of a divisible tax. The cross-referenced provisions provide exceptions to the prohibitions on levy, prohibit the initiation by the IRS of court proceedings to collect while the refund proceeding is pending, and provide that the statute of limitations for collection is suspended while levy is prohibited.

The proposed regulations implement the provisions of subsection 6331(k) as they relate to installment agreements. In addition to setting forth the periods during which levy is prohibited, they adapt the rules of paragraphs (3), (4), and (5) of subsection 6331(i) in a manner tailored to the installment agreement process. The legislative history accompanying RRA 1998 explains that Congress did not intend that levy would be prohibited if the IRS determined that an offer to compromise was submitted solely to delay collection. H.R. Conf. Rep. No. 509, 105th Cong., 2d Sess. 288 (1998). Because the legislative history indicates that Congress intended the same restrictions on levy with respect to offers in compromise be applicable to installment agreements, these proposed regulations adopt the same rule with respect to proposed installment agreements that are submitted solely to delay collection.

Explanation of Provisions

The proposed regulations provide that, subject to certain exceptions, the IRS may not levy to collect a liability while a proposal to enter into an installment agreement for payment of that liability is pending, for thirty days after rejection of such a proposal, while an installment agreement is in effect, for thirty days after termination of an installment agreement by the IRS, and during a timely filed appeal of a rejection or termination by the IRS. A proposed installment agreement is considered pending when it is accepted for processing by the IRS, and remains pending until the IRS accepts or rejects it or the taxpayer withdraws the proposal. If a proposed installment agreement does not contain sufficient information for the IRS to determine whether the proposal should be accepted, the IRS will request the additional necessary information from the taxpayer and provide a reasonable time period for the taxpayer to respond. The IRS may reject the proposed installment agreement if the requested information is not provided.

Collection by levy is not prohibited if the taxpayer waives the restriction on levy in writing, if the IRS determines that the proposed installment agreement was submitted solely to delay collection, or if the IRS determines that collection of the tax liability is in jeopardy.

The proposed regulations provide that the IRS may take actions other than levy to protect the interests of the United States with respect to collection of the liability to which an installment agreement or proposed installment agreement relates. Those actions include, but are not limited to: crediting an overpayment against the liability pursuant to section 6402, filing or refiling notices of Federal tax lien, and taking action to collect from persons liable for the tax but not named in the installment agreement.

Under the proposed regulations, the IRS cannot institute a court proceeding against the taxpayer named in the installment agreement to collect the tax covered by the installment agreement. The IRS, however, may file a claim in any bankruptcy proceeding, insolvency action, or interpleader case commenced by other creditors of the taxpayer. The IRS also may join the taxpayer in any suit instituted by or against another person liable for payment of the same liability—*i.e.*, in situations where the liability for the tax may be established or disputed. Such proceedings may involve taxes for which more than one person may be jointly and severally liable for the same tax, or may involve persons liable for related liabilities, such as a trust fund recovery penalty under section 6672 or a personal liability for excise tax under section 4103.

While an installment agreement allows the IRS to accept the payment of tax in installments, the agreement does not conclusively establish the taxpayer's liability. A taxpayer therefore is not prohibited from seeking a refund of taxes paid pursuant to an installment agreement. Allowing the IRS to join the taxpayer in a proceeding where the liability for the tax may be established or disputed will protect the Government from having to litigate the same tax in multiple forums only to face the argument in each separate case (including, potentially, from the taxpayer named in an installment agreement) that the person or persons not party to that suit were solely or principally liable for nonpayment of the taxes at issue. The proposed regulations provide, however, that if a taxpayer named in an installment agreement is joined in a proceeding and the IRS obtains a judgment against that person, then collection will continue to occur pursuant to the terms of the installment agreement.

The regulations provide that the statute of limitations for collection under section 6502 is suspended while a proposed installment agreement is pending, for thirty days after rejection or termination of an installment agreement, and during a timely filed appeal of the rejection or termination decision. The running of the collection statute resumes, however, after an installment agreement takes effect. The statute of limitations for collection shall continue to run if an exception under this section applies and levy is not prohibited with respect to the taxpayer.

These regulations apply to installment agreements proposed or entered into on or after the date final regulations are published in the **Federal Register**. However, the rules set forth in these regulations mirror practices the IRS has been following administratively since the enactment of RRA 1998.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronically generated comments that are submitted timely to the IRS. The IRS generally requests any comments on the clarity of the proposed rule and how it may be made easier to understand.

All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Frederick W. Schindler, Office of the Associate Chief Counsel (Procedure & Administration), Collection, Bankruptcy & Summonses Division.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 301 is proposed to be amended as follows:

PART 301 — PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 ***

Par. 2. Sections 301.6331–3 and 301.6331–4 are added to read as follows:

§ 301.6331–3 Restrictions on levy while offers to compromise are pending.

Cross-reference. For provisions relating to the making of levies while an offer to compromise is pending, see § 301. 7122–1T.

§ 301.6331–4 Restrictions on levy while installment agreements are pending or in effect.

(a) *Prohibition on levy*—(1) *In general.* No levy may be made to collect a tax liability that is the subject of an installment agreement during the period that a proposed installment agreement is pending with the Internal Revenue Service (IRS), for 30 days immediately following the rejection of a proposed installment agreement, during the period that an installment agreement is in effect, and for 30 days immediately following the termination of an installment agreement. If, within the 30 days following the rejection or termination of an installment agreement, the taxpayer files an appeal with the IRS Office of Appeals, no levy may be made while the rejection or termination is being considered by Appeals.

(2) *When a proposed installment agreement becomes pending.* A proposed installment agreement becomes pending when it is accepted for processing. The proposed installment agreement remains pending until the IRS accepts the proposal, the IRS notifies the taxpayer that the proposal has been rejected, or the proposal is withdrawn by the taxpayer. If a proposed installment agreement that has been accepted for processing does not contain sufficient information to permit the IRS to evaluate whether the proposal should be accepted, the IRS will request the taxpayer to provide the needed additional information. If the taxpayer does not submit the additional information that the IRS has requested within a reasonable time period after such a request, the IRS may reject the proposed installment agreement.

(3) *Revised proposals of installment agreements submitted following rejection.* If, following the rejection of a proposed installment agreement, the taxpayer makes a good faith revision of the proposal and submits the revision within 30 days of the date of rejection, no levy may be made while the IRS considers the revised proposal of an installment agreement.

(4) *Exceptions.* Paragraph (a)(1) of this section shall not prohibit levy if the taxpayer files a written notice with the IRS that waives the restriction on levy imposed by this section, the IRS determines that the proposed installment agreement was submitted solely to delay collection, or the IRS determines that collection of the tax to which the installment agreement or proposed installment agreement relates is in jeopardy. This section will not prohibit levy to collect from any person other than the person named on the installment agreement.

(b) *Other actions by the IRS while levy is prohibited*—(1) *In general.* The IRS may take actions other than levy to protect the interests of the Government with regard to the liability named in an installment agreement or proposed installment agreement. Those actions include, for example—

(i) Crediting an overpayment against the liability pursuant to section 6402;

(ii) Filing or refiling notices of Federal tax lien; and

(iii) Taking action to collect from any person who is not named on the installment agreement or proposed installment agreement but who is liable for the tax to which the installment agreement relates.

(2) *Proceedings in court.* The IRS will not begin a proceeding in court for the collection of any liability to which an installment agreement or proposed installment agreement relates against a person named in that installment agreement while levy is prohibited by paragraph (a)(1) of this section. In any refund action, however, the IRS may file a counterclaim or third-party complaint against a person without regard to whether that person is named in an installment agreement or proposed installment agreement. In addition, the IRS may join a person named in an installment agreement in any other proceeding in which liability for the tax that is the subject of the installment agreement may be established or disputed, and may file a claim in any bankruptcy proceeding, insolvency action, or interpleader case commenced by other creditors of the taxpayer. If a person named in an installment agreement is joined in a proceeding and the IRS obtains a judgment against that person, collection will continue to occur pursuant to the terms of the installment agreement.

(c) *Statute of limitations*—(1) *Suspension of the statute of limitations on collection.* The statute of limitations under section 6502 for collection of any liability shall be suspended during the period that a proposed installment agreement is pending with the IRS, for 30 days immediately following the rejection of a proposed installment agreement, and for 30 days immediately following the termination of an installment agreement. If, within the 30 days following the rejection or termination of an installment agreement, the taxpayer files an appeal with the IRS Office of Appeals, the statute of limitations for collection shall be suspended while the rejection or termination is being considered by Appeals. The statute of limitations for collection shall continue to run if an exception under paragraph (a)(4) of this section applies and levy is not prohibited with respect to the taxpayer.

(2) *Waivers of the statute of limitations on collection.* The IRS may continue to request, to the extent permissible under section 6502 and § 301.6159–1, that the taxpayer agree to a reasonable extension of the statute of limitations for collection.

(d) *Effective date.* This section is applicable on the date final regulations are published in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 16, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 17, 2002, 67 F.R. 18839)

Withdrawal of Previous Notice of Proposed Rulemaking; Notice of Proposed Rulemaking and Notice of Public Hearing

Arbitrage and Private Activity Restrictions Applicable to Tax-Exempt Bonds Issued by State and Local Governments; Investment-Type Property (Prepayment); Private Loan (Prepayment).

REG–105369–00

SUMMARY: This document contains proposed amendments to the final regulations on the arbitrage and private activity restrictions applicable to tax-exempt bonds issued by State and local governments. The proposed amendments affect issuers of tax-exempt bonds and provide guidance on the definitions of investment-type property and private loan to help issuers comply with the arbitrage and private activity restrictions. This document also provides notice of a public hearing on these proposed regulations. The previous notice of proposed rulemaking (REG–113526–98, 1999–2 C.B. 417), published on August 25, 1999, relating to arbitrage and related restrictions applicable to tax-exempt bonds issued by State and local governments, is withdrawn.

DATES: Written or electronic comments must be received by July 16, 2002. Outlines of topics to be discussed at the public hearing scheduled for September 24, 2002, at 10 a.m., must be received by September 10, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–105369–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–105369–00), courier's desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, submissions may be made electronically to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Johanna Som de Cerff, (202) 622–3980; concerning submissions and the hearing, Sonya Cruse, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 (the proposed regulations). On August 25, 1999, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG–113526–98) (64 FR 46320) (the 1999 proposed regulations) proposing to modify § 1.148–1(e) of the Income Tax Regulations to establish which prepayments for property or services give rise to investment-type property under section 148(b)(2)(D) of the Internal Revenue Code (Code). Numerous written comments responding to the 1999 proposed regulations were received, and a public hearing was held on January 12, 2000. In response to the extensive comments, particularly with regard to certain natural gas prepayment transactions discussed below, the 1999 proposed regulations are withdrawn and amendments to § 1.148–1(e) are proposed in accordance with this notice of proposed rulemaking. This notice of proposed rulemaking also proposes corresponding amendments to § 1.141–5(c)(2) (relating to the private loan financing test).

Explanation of Provisions

I. *Existing Definition of Investment-type Property*

With certain exceptions, section 148 prohibits the use of proceeds of a tax-exempt bond issue to acquire investment property with a yield that materially exceeds the yield on the issue. Section 148(b)(2)(D) provides that the term *investment property* includes *investment-type property*. Section 148(b)(2)(D) was added to the Code by the Tax Reform Act of 1986, Pub. L. No. 99–514, 100 Stat. 2085 (1986) (1986 Act). The Conference Committee Report states that the legislation "expands the types of investments of bond proceeds that are subject to the arbitrage restrictions to include all investment-type property (including other than customary prepayments)...." H.R. Conf. Rep. No. 99–841, pt. 2, at 745.

As an economic matter, prepayments for property or services generally contain a built-in investment return. That is, if a buyer of property or services makes a cash payment to the seller in advance of the seller's performance, the buyer may expect to receive an implicit investment return based on the time value of money. In the case of a prepayment financed with tax-exempt bond proceeds, the presence of a built-in investment return raises the issue of whether the prepayment gives rise to investment-type property.

The existing regulations, at § 1.148–1(e)(2), contain rules for determining when a prepayment for property or services results in investment-type property. Under that provision, a prepayment generally gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. However, a prepayment does not give rise to investment-type property under the existing regulations if (1) it is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment (the business purpose exception); or (2) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing (the customary exception).

II. *1999 Proposed Amendments to the Definition of Investment-type Property*

The 1999 proposed regulations proposed a modification to § 1.148–1(e)(2) to establish that a prepayment of a contract for property or services that is made after the date that the contract is entered into can give rise to investment-type property. This modification was proposed in light of the opinion in *City of Columbus v. Commissioner*, 112 F.3d 1201 (D.C. Cir. 1997), which concluded that a 1994 prepayment by a city of its indebtedness to a state did not constitute a prepayment for property the city acquired in

1967. The proposed amendment to § 1.148–1(e)(2) addressed only the narrow issue of whether a prepayment for property or services after the execution of a contract to buy the property or services can give rise to investment-type property.

Commentators generally agreed with the suggestion that a prepayment for property or services can occur after the date the purchase contract is executed. The proposed regulations retain the proposed change to § 1.148–1(e)(2), with clarifying modifications that are consistent with this concept.

III. Definition of Investment-type Property in the Proposed Regulations

Although commentators generally agreed with the 1999 proposed amendments to § 1.148–1(e)(2), they requested additional clarification of other aspects of the definition of *investment-type property*. After considering all of the comments, Treasury and the IRS have determined that additional changes to the definition are needed to provide certainty to issuers and the IRS in a manner that is consistent with the broad scope of the investment-type property concept. To allow for public comment, these additional changes are issued in proposed form. Furthermore, to provide issuers with immediate certainty, issuers may rely on the proposed regulations to the extent specified below.

Commentators generally did not recommend modifying the basic framework for determining whether a prepayment gives rise to investment-type property under § 1.148–1(e)(2). The proposed regulations retain this basic structure, but make certain modifications. In particular, the proposed regulations: (1) amend the business purpose exception; (2) retain the customary exception in its present form; (3) add an exception for certain prepayments by municipal utilities to acquire a supply of natural gas; and (4) add a *de minimis* exception for prepayments made within 90 days of delivery of the property or services. In addition, the proposed regulations state that the Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

A. *Business purpose exception*

As indicated, the existing regulations provide that a prepayment does not give rise to investment-type property if it is made for a substantial business purpose other than investment return and the issuer has no commercially reasonable alternative to the prepayment. This provision, which was intended to be a narrow exception to the definition of investment-type property, has raised difficult interpretive questions. For example, in many instances it may be unclear whether the alternatives available to the issuer are "commercially reasonable."

Commentators suggested certain changes to the provision to clarify its application. For example, they suggested that a prepayment should be considered made for a substantial business purpose other than investment return if the effect of the prepayment is (1) to fix the price of the property or service, (2) to assure a supply of the property or service, (3) to guarantee delivery of the property or service at a location favorable to the issuer, or (4) to enable the issuer to obtain a price discount that materially exceeds the investment return that could be earned between the time the prepayment is made and the time the property or services are delivered. Commentators suggested that an alternative should be viewed as "commercially reasonable" if it is reasonably available to the issuer, it would achieve the same substantial business purpose as the prepayment except that no investment return is received, and it is not more expensive by an amount that materially exceeds the investment return from the prepayment. Some commentators recommended that a safe harbor be added under which an alternative would not be considered commercially reasonable if the cost of the alternative exceeded the cost of the prepayment by a specified amount on a present value basis.

Treasury and the IRS have considered these suggested factors and have concluded that they do not, in and of themselves, represent administrable standards for distinguishing between prepayments that are made primarily for arbitrage purposes and those that are not. That is, a prepayment transaction may contain one or more of these features, even if it is primarily arbitrage-motivated. Therefore, the proposed regulations do not adopt these suggested amendments. Nevertheless, as discussed below, these factors are taken into account, together with all the other facts and circumstances, in determining whether a prepayment satisfies the business purpose exception as revised by the proposed regulations.

In this regard, the proposed regulations amend the business purpose exception in order to clarify that it is to be applied narrowly in a manner that is consistent with the broad scope of the investment-type property concept. In particular, under the proposed regulations a prepayment meets the business purpose exception if the facts and circumstances clearly establish that the primary purpose for the prepayment is to accomplish one or more substantial business purposes that (1) are unrelated to any investment return based on the time value of money, and (2) cannot be accomplished without the prepayment. This exception is intended to be very narrow and to apply only in very unique circumstances, such as the situation illustrated by an example in the proposed regulations.

B. *Customary exception*

As indicated, the existing regulations provide that a prepayment does not give rise to investment-type property if prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing. This provision implements the legislative history cited above that indicates that customary prepayments should not result in investment-type property.

Commentators suggested that a safe harbor be added for determining a "substantial percentage" of similarly situated persons. However, Treasury and the IRS have concluded that the determination of whether a transaction is customary is appropriately made on a case-by-case basis, taking into account all the facts and circumstances, rather than by reference to a precise mathematical formula or predetermined percentage. Therefore, the proposed regulations do not adopt this suggested change.

Commentators also recommended that the "substantial percentage" requirement should be deemed satisfied if a substantial number of similarly situated persons who

are not beneficiaries of tax-exempt financing make a similarly sized prepayment. The proposed regulations do not adopt this comment because the incidence of a particular number of transactions by similarly situated persons may not establish that the transaction is customary if those persons represent only a small percentage of all the similarly situated persons.

Finally, some commentators suggested that the customary exception should be automatically satisfied if the issuer and the supplier of the property or services certify reasonably and in good faith that its requirements are met. The proposed regulations do not adopt this comment because a certification by the parties to a transaction should not be sufficient to establish the legal conclusion that the transaction meets the requirements of the exception.

C. *Certain prepayments to acquire a supply of natural gas*

The preamble to the 1999 proposed regulations identified certain transactions involving the issuance of bonds to prepay for a supply of natural gas and the simultaneous execution by the issuer of a commodity swap under which the issuer receives fixed payments and makes variable payments based on an index. The 1999 preamble stated that Treasury and the IRS were concerned that the transactions create investment-type property and requested comments on the transactions.

Most, but not all, of the commentators disagreed with the suggestion that the identified transactions should result in investment-type property. They stated that deregulation of the natural gas industry has threatened the ability of municipal utilities to obtain a secure supply of natural gas on commercially reasonable terms. They stated that the natural gas prepayment transactions are necessary to obtain a guaranteed supply of natural gas on favorable terms in light of deregulation.

The proposed regulations add an exception to the definition of investment-type property for certain natural gas prepayments that are made by or for one or more utilities that are owned by a governmental person, as defined in § 1.141–1(b) (for example, where a joint action agency acquires a natural gas supply for one or more municipal gas or electric utilities). The exception applies only if at least 95 percent of the natural gas purchased with the prepayment is to be consumed by retail customers in the service area of a municipal gas utility, or used to produce electricity that will be furnished to retail customers that a municipal electric utility is obligated to serve under state or Federal law. For this purpose, the service area of a municipal gas utility is defined as (1) any area throughout which the municipal utility provided (at all times during the five-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area, or (2) any area where the municipal utility is obligated under state or Federal law to provide gas distribution services as provided in such law. Issuers may apply principles similar to the rules of § 1.141–12 in order to cure a violation of this 95 percent requirement.

A transaction will not fail to qualify for this exception by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. For this purpose, a swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas supply contract or another swap contract).

Comments are requested on the exception for natural gas prepayments in the proposed regulations, including the definition of service area and the workability of the 95 percent test.

D. *De minimis prepayments*

Commentators recommended adding to the regulations a *de minimis* exception under which prepayments that are made in small amounts or shortly before the property or services are delivered, would be disregarded. Treasury and the IRS recognize that prepayments made shortly before the property or services are delivered are unlikely to be arbitrage-motivated. Based on this consideration, and to provide administrative certainty, the proposed regulations add an exception for prepayments that are made within 90 days of the date of delivery of the property or services. However, the proposed regulations do not provide an exception for small prepayments because a prepayment may be made primarily for arbitrage purposes even if it is a small amount.

E. *Timing mismatch between payment and delivery of property or services*

The preamble to the 1999 proposed regulations requested comments regarding the proper treatment of contracts that provide for a timing mismatch between the buyer's cash payments and the seller's delivery of property or services.

Commentators generally expressed the view that, depending on the particular facts, payments made over time may give rise to investment-type property when the payment schedule does not match the schedule for the provision of property or services. The commentators did not recommend any changes to the regulations on this issue. Treasury and the IRS have determined that § 1.148–1(e)(2) appropriately addresses mismatches in payment and delivery obligations. Therefore, the proposed regulations do not propose any amendments in this regard.

F. *Prepayments of capital charges*

Some commentators recommended that the regulations be modified to provide that a prepayment does not give rise to investment-type property if it is in substance a reimbursement to a seller of all or a portion of the seller's capital costs of a specific, tangible project through which the seller produces or delivers a service or commodity. The proposed regulations do not contain a specific exception for prepayments that reimburse a seller for its capital costs because a prepayment may be made primarily for arbitrage purposes even if it effectively reimburses the seller for capital costs. Nevertheless, this factor is taken into account, together with all the other facts and circumstances, in determining whether a prepayment meets the business purpose exception.

IV. *Private Loans*

With certain exceptions, interest on an issue that meets the private loan financing test is not excluded from gross income. Under section 141(c), an issue generally meets the private loan financing test if more than the lesser of 5 percent or $5

million of its proceeds are used to make loans to nongovernmental persons. Section 1.141–5(c)(1) states that, for purposes of the private loan financing test, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction rather than its form. *See also* H.R. Conf. Rep. No. 99–841, pt. 2, at 692.

The existing regulations, at § 1.141–5(c)(2)(ii), provide that a prepayment for property or services generally is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. However, under the existing regulations a prepayment is not treated as a loan for purposes of the private loan financing test if (1) it is made for a substantial business purpose other than providing a benefit of tax-exempt financing to the seller and the issuer has no commercially reasonable alternative to the prepayment; or (2) prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing. The proposed regulations amend the private loan provisions of §1.141–5(c)(2) to conform to the amendments to the definition of investment-type property in this notice of proposed rulemaking.

Proposed Effective Date

The proposed regulations will apply to bonds sold on or after the date of publication of final regulations in the **Federal Register**. However, issuers may apply the proposed regulations in whole, but not in part, to any issue that is sold on or after the date the proposed regulations are published in the **Federal Register** and before the effective date of the final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the IRS. The Treasury Department and IRS specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 24, 2002, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the lobby more than 30 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by July 16, 2002, and submit an outline of the topics to be discussed and the amount of time to be devoted to each topic by September 10, 2002.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Rebecca L. Harrigal and Johanna Som de Cerff, Office of Chief Counsel (TE/GE), IRS, and Stephen J. Watson, Office of Tax Policy, Treasury Department. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.141–5, paragraph (c) is amended as follows:

1. Paragraph (c)(2)(ii) introductory text is revised.

2. Paragraph (c)(2)(ii)(A) is revised.

3. Paragraph (c)(2)(ii)(B) is amended by removing the period at the end of the paragraph and adding a semicolon in its place.

4. Paragraphs (c)(2)(ii)(C), (c)(2)(ii)(D), and (c)(2)(iii) are added.

The revisions and additions read as follows:

§ 1.141–5 Private loan financing test.

* * * * *

(c) * * *

(2) * * *

(ii) *Certain prepayments treated as loans.* Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if—

(A) The primary purpose for the prepayment is to accomplish one or more substantial business purposes that—

(*1*) Are unrelated to providing any benefit of tax-exempt financing to the seller; and

(*2*) Cannot be accomplished without the prepayment;

* * * * *

(C) The prepayment is made within 90 days of the date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(D) The prepayment meets the requirements of § 1.148–1(e)(2)(ii) (relating to certain prepayments to acquire a supply of natural gas).

(iii) *Additional prepayments as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment is not treated as a loan for purposes of the private loan financing test.

* * * * *

Par. 3. In § 1.148–1, paragraphs (e)(1) and (2) are revised to read as follows:

§ 1.148–1 Definitions and elections.

* * * * *

(e) *Investment-type property*—(1) *In general.* Investment-type property includes any property, other than property described in sections 148(b)(2)(A), (B), (C), or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money.

(2) *Prepayments*—(i) *In general.* Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if—

(A) The primary purpose for the prepayment is to accomplish one or more substantial business purposes that—

(*1*) Are unrelated to any investment return based on the time value of money; and

(*2*) Cannot be accomplished without the prepayment;

(B) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(C) The prepayment is made within 90 days of the date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(D) The prepayment meets the requirements of paragraph (e)(2)(ii) of this section.

(*ii*) *Certain prepayments to acquire a supply of natural gas*—(A) *In general.* A prepayment meets the requirements of this paragraph (e)(2)(ii) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person, as defined in § 1.141–1(b) (*municipal utility*), to purchase a supply of natural gas; and

(*2*) At least 95 percent of the natural gas purchased with the prepayment is to be consumed by retail gas customers in the service area (as defined in paragraph (e)(2)(ii)(B) of this section) of a municipal utility, or used to produce electricity that will be furnished to retail electric customers that a municipal utility is obligated to serve under state or Federal law. An obligation that arises solely by reason of a contract is not an obligation to serve under state or Federal law.

(B) *Service area.* For purposes of paragraph (e)(2)(ii)(A)(*2*) of this section, the service area of a municipal utility shall consist of—

(*1*) Any area throughout which the municipal utility provided (at all times during the 5-year period ending on the issue date) gas transmission or distribution service, and any area that is contiguous to such an area; or

(*2*) Any area where the municipal utility is obligated under state or Federal law to provide gas distribution services as provided in such law.

(C) *Commodity swaps.* A prepayment does not fail to meet the requirements of this paragraph (e)(2)(ii) by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas supplier), or between the gas supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas supply contract or another swap contract).

(iii) *Additional prepayments as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

(iv) *Examples.* The following examples illustrate the application of this paragraph (e)(2):

Example 1. Prepayment after contract is executed. In 1998, City A enters into a ten-year contract with Company Y. Under the contract, Company Y is to provide services to City A over the term of the contract and in return City A will pay Company Y for its services as they are provided. In 2004, City A issues bonds to finance a lump sum payment to Company Y in satisfaction of City A's obligation to pay for Company Y's services to be provided over the remaining term of the contract. The use of bond proceeds to make the lump sum payment constitutes a prepayment for services under paragraph (e)(2)(i) of this section, even though the payment is made after the date that the contract is executed.

Example 2. Prepayment necessary to accomplish substantial business purpose. Authority is a governmental unit that furnishes electricity to the general public. In 1995, Authority enters into a 15–year agreement (the Agreement) with Power Company to obtain certain of its power requirements. In 2003, Authority enters into another contract (the Purchase Contract) with Power Company to obtain a specified amount of additional firm power through 2013. The rates paid by Authority under the Purchase Contract are based on a fixed capacity charge, which reflects Power Company's average cost of certain plants and equipment, and a variable energy charge, which reflects Power Company's average system energy costs to operate the utility, primarily fuel costs. Simultaneously with entering into the Purchase Contract, Authority issues a $30 million issue with a 6 percent yield and uses the proceeds to make a lump sum payment to Power Company to prepay for the entire fixed capacity charge under the Purchase Contract. Authority pays the variable energy charges as energy is actually delivered. Power Company reports the lump sum payment for Federal tax purposes as income from the sale of capacity. Power Company also agrees to certain concessions under the Agreement, including the elimination of floors on capacity charges and a moratorium on capacity charge increases for five years. The discount rate used to compute the amount of the prepayment is 18 percent, compounded semi-annually. Power Company's taxable borrowing rate for a loan of a comparable size to the prepayment, with a term that coincides with the term of the Purchase Contract, is 8 percent, compounded semiannually. The prepayment allows Power Company to offer a low capacity charge to Authority, yet prevent other wholesale customers from taking advantage of the proposal. Under Federal rate-making guidelines, if Power Company had offered Authority a contract based on fixed periodic capacity charges, Power Company would have been obligated to offer the same capacity charges to its other wholesale customers (which would have been expected to accept the offer). Power Company is willing to offer Authority the lower capacity charge and to make the other concessions because it owns surplus generating capacity. Thus, it is important to Power Company to maintain its customer base. The loss of a significant customer

such as Authority would require that Power Company either succeed in obtaining regulatory authorization to increase its rates charged to other customers or suffer a diminished return on capital. Power Company will not build additional generating facilities directly or indirectly by reason of its obligations under the Purchase Contract, and at the time it entered into the Purchase Contract, it had already incurred capital costs of facilities, which, if allocated to Authority's demands for energy under the Purchase Contract, would exceed the up-front capacity charge. Under paragraph (e)(2)(i)(A) of this section, the prepayment does not give rise to investment-type property.

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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 12, 2002, 4:12 p.m., and published in the issue of the Federal Register for April 17, 2002, 67 F.R. 18835)

Changes in Method of Accounting

Announcement 2002–45

PURPOSE

Beginning with the publication of Rev. Proc. 2001–10 (2001–1 C.B. 272) superseding Rev. Proc. 2000–22 (2000–1 C.B. 1008), the Internal Revenue Service (IRS) and Treasury Department have been working to reduce the administrative and tax compliance burdens on small business taxpayers and to minimize disputes between the IRS and these taxpayers regarding the requirement to use an accrual method of accounting under § 446 of the Internal Revenue Code because of the requirement to account for inventories under § 471. Rev. Proc. 2001–10 permits any small business taxpayer having average annual gross receipts of $1 million or less (other than tax shelters) to use the cash receipts and disbursements method of accounting (the cash method), regardless of the nature of its trade or business. Rev. Proc. 2001–10 also permits these businesses to treat as non-incidental materials and supplies under § 1.162–3 of the Income Tax Regulations items that otherwise would be accounted for as inventory.

In December 2001, the IRS published Notice 2001–76 (2001–52 I.R.B. 613) proposing a revenue procedure (the proposed revenue procedure) that would allow qualifying small business taxpayers with average annual gross receipts of $10 million or less to use the cash method with respect to eligible trades or businesses. Notice 2001–76 also requested comments from the public regarding the proposed revenue procedure. This announcement discusses certain issues raised by those comments and the manner in which those issues are addressed in the final revenue procedure.

The final revenue procedure appears in this Internal Revenue Bulletin as Rev. Proc. 2002–28.

CHANGES TO THE PROPOSED REVENUE PROCEDURE

General Application of Rev. Proc. 2002–28

Several commentators asked for assistance in understanding which taxpayers are eligible to elect the cash method under the revenue procedure. In response, a flow chart has been added as an appendix to Rev. Proc. 2002–28. This flow chart provides a short-hand explanation of the scope and application of the final revenue procedure and helps explain the interaction of the revenue procedure with other authorities (such as § 448). Taxpayers should keep in mind that it is less detailed than the actual provisions of the revenue procedure and should be used only as a guide.

Many commentators asked whether the proposed revenue procedure waives the statutory restrictions placed on the use of the cash method in § 448. Rev. Proc. 2002–28 clarifies that the provisions of § 448 are not affected by the revenue procedure.

Many commentators requested clarification of the options available to qualifying small businesses under the proposed revenue procedure in choosing their overall method of accounting as well as their method of accounting for inventoriable items. In response to this request, Rev. Proc. 2002–28 lists the three options available under the revenue procedure to qualifying small business taxpayers who choose not to use an overall accrual method and an inventory method of accounting.

Determination and Qualification of a Taxpayer's Principal Business Activity

The proposed revenue procedure allowed any taxpayer whose principal business activity is not described in a prohibited North American Industry Classification System ("NAICS") code to use the cash method for all of its trades or businesses. Several commentators expressed concern that because the proposed revenue procedure looks only to the gross receipts of the taxpayer's most recent taxable year in determining a taxpayer's principal business activity, temporary fluctuations in the nature of the taxpayer's trades or businesses could change its principal business activity for purposes of the revenue procedure and thus its continued ability to use the cash method for all of its trades or businesses. In response, the final revenue procedure adopts a two-prong principal business activity test. A taxpayer may determine its principal business activity using either (i) the gross receipts for its prior taxable year, or (ii) the average annual gross receipts for its three most recent prior taxable years.

Rev. Proc. 2002–28 also clarifies that the revenue procedure may be used only by those taxpayers who did not previously change (and were not required to have previously changed) from the cash method to an accrual method for any trade or business as a result of their trade or business becoming ineligible to use the cash method under the revenue procedure. Such taxpayers may, however, apply the revenue procedure to separate trades or businesses with complete and separable books and records that are not described in an ineligible NAICS code in section 4.01(1)(a), that are service businesses under section 4.01(1)(b), or that are custom manufacturers under section 4.01(1)(c).

A few commentators requested additional guidance regarding how the proposed revenue procedure would apply to a taxpayer in its first year of business, given that it would not have any prior year gross receipts for purposes of the principal business activity test. Rev. Proc. 2002–28 provides that a taxpayer in its first year of business may use its current year gross receipts to determine its principal business activity.

Commentators requested guidance on the interaction of the service provider safe harbor in section 4.01(1)(b) and the custom manufacturer safe harbor in section 4.01(1)(c) with the NAICS code safe harbor of section 4.01(1)(a). In response to this request, Rev. Proc. 2002–28 clarifies that a taxpayer may qualify to apply the revenue procedure to all of its trades or businesses by meeting the requirements of either the NAICS code safe harbor in section 4.01(1)(a), the service provider safe harbor in section 4.01(1)(b), or the custom manufacturer safe harbor in section 4.01(1)(c). A taxpayer's principal business activity must qualify under only one of these three provisions for all of the taxpayer's trades or businesses to be eligible to use the revenue procedure.

Inventoriable Items Treated as Materials and Supplies that Are Not Incidental under § 1.162–3

In Rev. Proc. 2001–10, the IRS determined that, for reasons of administrative convenience and reduction of taxpayer burden, taxpayers need not apply the uniform capitalization rules of § 263A to inventoriable items treated as non-incidental materials and supplies under § 1.162–3 for purposes of that revenue procedure. Several commentators suggested that the provisions of § 263A similarly should not apply to inventoriable items treated as non-incidental materials and supplies for purposes of the proposed revenue procedure. The IRS and Treasury Department agree with this comment and have included this provision in Rev. Proc. 2002–28.

Commentators requested additional guidance regarding when the costs of materials and supplies that are not incidental may be deducted. In response to this request, Rev. Proc. 2002–28 provides additional examples to illustrate the appropriate timing of such deductions under § 1.162–3. One of these examples clarifies that under the cash method, the cost of raw materials may not be deducted until the product is provided to the customer (the costs must be added to the basis of a manufactured item rather than currently deducted). In addition, Rev. Proc. 2002–28 clarifies that in determining the amount of the deduction for inventoriable items that are treated as non-incidental materials and supplies, the taxpayer may use a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, but that other methods, such as a last-in, first-out (LIFO) method, may not be used.

Other Issues

Several commentators requested clarification of the open accounts receivable (that is, for purposes of Rev. Proc. 2002–28, a receivable due in full in 120 days or less) rule in section 4.03 of the proposed revenue procedure. In response to this request, Rev. Proc. 2002–28 contains an additional example to illustrate the rule.

Several commentators requested additional guidance on the treatment of specific methods of accounting for particular items (such as specific methods for long-term contracts) for taxpayers using one of the options under Rev. Proc. 2002–28. In response, the final revenue procedure clarifies that taxpayers may, in some cases, be able to retain their specific method of accounting even when they use one of the options under the revenue procedure.

Additional Safe Harbor Explanations of Certain Qualified Plan Distributions

Announcement 2002–46

This announcement contains a safe harbor explanation in Spanish that plan administrators can provide to Spanish-speaking employees who are recipients of eligible rollover distributions from qualified employer plans, tax-sheltered annuities or governmental § 457 plans in order to satisfy § 402(f) of the Internal Revenue Code. Previously, in Notice 2002–3 (2002–2 I.R.B. 289), the Internal Revenue Service published these safe harbor explanations in English.

EXPLICACIÓN DEL CONCEPTO DE REFUGIO TRIBUTARIO EN LOS PLANES CALIFICADOS CONFORME A LA SECCIÓN 401(a), LA SECCIÓN 403(a), PLANES DE ANUALIDADES, O LA SECCIÓN 403(b), ANUALIDADES CON PAGO DEL IMPUESTO DIFERIDO

NOTIFICACIÓN TRIBUTARIA ESPECIAL SOBRE LOS PAGOS DE PLANES

En esta notificación se explica la forma en que usted puede continuar aplazando el pago del impuesto federal sobre el ingreso en sus ahorros de la jubilación en el [INSERTAR AQUÍ EL NOMBRE DEL PLAN] (en adelante denominado el "Plan"). La notificación contiene también una información importante que usted debe conocer antes de decidir cómo va a recibir los beneficios o pagos de su Plan.

Esta notificación se la envía a usted [INSERTAR AQUÍ EL NOMBRE DEL ADMINISTRADOR DEL PLAN O, EN EL CASO DE UNA ANUALIDAD CONFORME A LA SECCIÓN 403(b), ANUALIDADES CON PAGO DEL IMPUESTO DIFERIDO, LA ENTIDAD PAGADORA] (en adelante denominado el "Administrador del Plan"), porque toda la cantidad o parte del pago que va usted a recibir dentro de poco del Plan podría cumplir con los requisitos establecidos para una reinversión por usted o su Administrador del Plan en una cuenta IRA tradicional o en un plan patronal calificado. Una reinversión es un pago o transferencia efectuado por usted o el Administrador del Plan de todo o parte de su beneficio a otro plan o a una cuenta IRA que le permite continuar posponiendo el pago del impuesto sobre ese beneficio hasta que se le pague. Su pago no puede reinvertirse en una cuenta Roth IRA, en una cuenta SIMPLE IRA ni en una cuenta de ahorro para la educación Coverdell Education Savings Account (anteriormente conocida como cuenta IRA para educación). Un "plan patronal calificado" consiste en un plan que reúne los requisitos legales establecidos en la sección 401(a) del Código Tributario, que comprende los planes siguientes: plan 401(k) del empleador, plan de participación en los beneficios, plan de beneficios definidos, plan de acciones gratuitas y plan de contribución dineraria patronal al fondo de pensiones; un plan de anualidad de la sección 403(a), una anualidad con pago del impuesto diferido de la sección 403(b), y un plan calificado de la sección 457(b) mantenido por un empleador del gobierno (plan 457 gubernamental).

Un plan patronal calificado no está legalmente obligado a aceptar una reinversión. Antes de decidir reinvertir su pago en otro plan patronal, deberá averiguar si el plan acepta reinversiones y, en caso afirmativo, los tipos de distribuciones que acepta como reinversión. Deberá informarse también sobre los documentos requeridos que han de llenarse para que el plan receptor acepte una reinversión. Aunque un plan acepte reinversiones, podría no aceptar reinversiones de ciertos tipos de distribuciones, tales como las cantidades después de pagar los impuestos. Cuando éste sea el caso y su distribución comprenda sumas después de pagar los impuestos, usted podría en su lugar, si lo desea, reinvertir su distribución en una cuenta IRA tradicional o bien dividir la cantidad de la reinversión entre el plan patronal en el que va a participar y una cuenta IRA tradicional. Si un plan patronal acepta su reinversión, el mismo podría limitar las distribuciones posteriores de la cantidad de reinversión o requerir el consentimiento de su cónyuge para cualquier distribución posterior. Una distribución posterior del plan que acepta su reinversión podría estar también sujeta a un tratamiento tributario distinto al de las distribuciones de este Plan. Consulte con el administrador del plan que va a recibir su reinversión antes de hacer la reinversión.

Si tiene usted algunas preguntas que hacer después de leer esta notificación, puede ponerse en contacto con el Administrador de su plan [INSERTAR AQUÍ EL NÚMERO DE TELÉFONO U OTRA INFORMACIÓN DE CONTACTO].

RESUMEN

Hay dos maneras en que usted podría recibir un pago del Plan que reúne los requisitos exigidos para una reinversión:

(1) Ciertos pagos pueden hacerse directamente a una cuenta IRA tradicional que usted tenga o a un plan patronal calificado que lo aceptará y mantendrá para su beneficio ("REINVERSIÓN DIRECTA"). O

(2) Pago HECHO A USTED.

Si usted opta por una REINVERSIÓN DIRECTA:

- Su pago no tributará en el año actual ni se le hará ninguna retención del impuesto sobre el ingreso.
- Usted decide si su pago se hará directamente a su cuenta IRA tradicional o a un plan patronal calificado que acepta su reinversión. Su pago no puede reinvertirse en una cuenta Roth IRA, una cuenta SIMPLE IRA ni en una cuenta de ahorro para educación Coverdell Education Savings Account porque éstas no son cuentas IRA tradicionales.
- La parte tributable de su pago se gravará más tarde cuando la saque de su cuenta IRA tradicional o del plan patronal calificado. Dependiendo del tipo de plan de que se trate, la distribución posterior podría estar sujeta a un tratamiento tributario diferente al que se aplicaría si usted recibiera una distribución tributable de este Plan.

Si opta por un pago HECHO A USTED del Plan que reúne los requisitos exigidos para una reinversión:

- Recibirá solamente el 80% de la cantidad tributable del pago, porque el Administrador del Plan tiene que retener el 20% de esa cantidad y enviarla al IRS como retención del impuesto sobre el ingreso para ser acreditada contra sus impuestos.
- La cantidad tributable de su pago se gravará en el año actual, a menos que la reinvierta. En ciertas circunstancias, usted podrá aplicar unas reglas tributarias especiales que podrían reducir el impuesto que debe. Sin embargo, si usted recibe el pago antes de cumplir 59 años y medio, tendría que pagar un impuesto adicional del 10%.
- Usted puede reinvertir todo o parte del pago, transfiriéndolo a su cuenta IRA tradicional o a un plan patronal calificado que acepte su reinversión dentro de un plazo de 60 días a partir del recibo del pago. La cantidad reinvertida no tributará hasta que usted no la saque de su cuenta IRA tradicional o del plan patronal calificado.
- Si usted desea reinvertir el 100% del pago en una cuenta IRA tradicional o en un plan patronal calificado, *tendrá que obtener el dinero de otra fuente para reponer el 20% de la parte tributable que se le retuvo.* Si reinvierte solamente el 80% del pago que recibió, tendrá que pagar impuestos sobre el 20% que se le retuvo y no se reinvierte.

Su Derecho a Renunciar al Plazo de Notificación de 30 Días. En general, no podrá hacerse una reinversión directa ni un pago del plan hasta 30 días, como mínimo, después de haber recibido esta notificación. Por lo tanto, después de recibir esta notificación, tendrá un plazo, como mínimo, de 30 días para pensar si va o no a reinvertir directamente su retiro. Si no quiere esperar hasta que finalice ese plazo de notificación de 30 días para la tramitación de su opción, puede renunciar al mismo, haciendo una elección afirmativa e indicando si desea o no una reinversión directa. Su retiro será entonces tramitado de acuerdo con su opción lo antes posible después de recibirla el Administrador del Plan.

MÁS INFORMACIÓN

I. PAGOS QUE PUEDEN Y QUE NO PUEDEN REINVERTIRSE

Los pagos recibidos del Plan pueden ser "distribuciones de reinversión calificadas", o sea, que pueden reinvertirse en una cuenta IRA tradicional o en un plan patronal calificado que acepte reinversiones. Los pagos de un plan no pueden reinvertirse en una cuenta Roth IRA, una cuenta SIMPLE IRA ni en una cuenta Coverdell Education Savings Account [cuenta de ahorro para educación]. El administrador de su Plan podrá decirle qué parte de su pago es una distribución de reinversión calificada.

Contribuciones después de pagar los impuestos. Si usted hizo contribuciones al Plan después de pagar los impuestos, estas contribuciones pueden reinvertirse en una cuenta IRA tradicional o en ciertos planes patronales que acepten reinversiones de contribuciones después de pagar los impuestos. Se aplican las reglas siguientes:

a) Reinversión en una cuenta IRA tradicional. Puede reinvertir sus contribuciones después de pagar los impuestos en una cuenta IRA tradicional directa o indirectamente. El administrador de su plan podrá decirle qué cantidad de su pago es la parte tributable y qué cantidad es la parte después de los impuestos.

   Si reinvierte contribuciones después de pagar los impuestos en una cuenta IRA tradicional, será su responsabilidad mantener un registro, e informar al IRS en las formas correspondientes, de la cantidad de esas contribuciones después de los impuestos. Esto permitirá calcular la cantidad no tributable de cualquier distribución futura de la cuenta IRA tradicional.

   Una vez realizada la reinversión de sus contribuciones después de los impuestos en una cuenta IRA tradicional, estas cantidades NO PODRÁN reinvertirse más tarde en un plan patronal.

b) Reinversión en un Plan Patronal. Puede reinvertir contribuciones después del impuesto procedentes de un plan patronal que cumpla con los requisitos establecidos conforme a la sección 401(a) o un plan de anualidad de la sección 403(a) del Código Tributario en otro plan semejante utilizando una reinversión directa, si este otro plan mantiene una contabilidad separada de las cantidades reinvertidas, incluida una contabilidad separada para las contribuciones del empleado después del impuesto y de los ingresos devengados en dichas contribuciones. Asimismo, puede usted reinvertir también contribuciones después del impuesto de una anualidad con pago del impuesto diferido de la sección 403(b) en otra anualidad del mismo tipo, utilizando una reinversión directa, si la otra anualidad con pago del impuesto diferido mantiene una contabilidad separada para las cantidades reinvertidas, incluida una contabilidad separada para las contribuciones del empleado después de pagar los impuestos y de los ingresos devengados en dichas contribuciones. Usted NO PUEDE reinvertir contribuciones después del impuesto en un plan 457 gubernamental. Si quiere reinvertir sus contribuciones después del impuesto en un plan patronal que acepta dichas reinversiones, no podrá ordenar que le paguen a usted primero las contribuciones después del impuesto. Tendrá que dar instrucciones al Administrador del Plan de dicho Plan para que haga una reinversión directa en su nombre. Además, usted no puede reinvertir primero contribuciones después del impuesto en una cuenta IRA tradicional y reinvertir luego esa cantidad en un plan patronal.

Los tipos de pagos que se indican a continuación *no pueden* reinvertirse:

Pagos espaciados en períodos largos de tiempo. No podrá reinvertir un pago si éste forma parte de una serie de pagos iguales (o casi iguales) que se hacen al menos una vez al año y que durarán:

- Toda su vida (o un período basado en su expectativa de vida). O
- Toda su vida y toda la vida de su beneficiario (o un período basado en las expectativas de vida de ambos). O
- Un período de 10 o más años.

Pagos mínimos requeridos. A partir de la fecha en que cumpla 70 años y medio o se jubile, la fecha que ocurra más tarde, cierta cantidad de su pago no podrá reinvertirse, porque existe un "pago mínimo requerido" que deberá hacérsele a usted. Se aplican unas reglas especiales si usted posee una participación de más del 5% en la empresa de su empleador.

Distribuciones por dificultades excepcionales. Una distribución por dificultades excepcionales no puede reinvertirse.

Dividendos de un plan ESOP. Los dividendos en efectivo que usted percibe de acciones poseídas en un plan de compra de acciones para los empleados u obreros (ESOP) no pueden reinvertirse.

Distribuciones correctivas. Una distribución que se hace para remediar una prueba de no discriminación no satisfecha o porque los límites legales establecidos para ciertas contribuciones fueron excedidos no puede reinvertirse.

Préstamos tratados como distribuciones. La cuantía de un préstamo con cargo a un plan considerada una distribución tributable por incumplimiento de pago no puede reinvertirse. Sin embargo, una cuantía compensatoria del préstamo puede reinvertirse, como se explicará en la Parte III más adelante. Pregunte al Administrador del Plan de dicho Plan si la distribución de su préstamo cumple con los requisitos exigidos para tratarlo como reinversión.

El Administrador del Plan de dicho Plan podrá indicarle si su pago incluye cantidades que no pueden reinvertirse.

II. *REINVERSIÓN DIRECTA*

UNA REINVERSIÓN DIRECTA es un pago directo de la cantidad de sus beneficios recibidos del Plan en una cuenta IRA tradicional o en un plan patronal calificado que lo acepte. Usted puede optar por una REINVERSIÓN DIRECTA de todo o de cualquier parte de su pago que sea una distribución de reinversión calificada, según se ha descrito anteriormente en la Parte I. Cualquier parte tributable de su pago de la que opte por una REINVERSIÓN DIRECTA se gravará más tarde cuando la saque de su cuenta

IRA tradicional o del plan patronal calificado. Además, no se requerirá hacer ninguna retención del impuesto sobre el ingreso en ninguna parte tributable de sus beneficios del Plan de la que opte por una REINVERSIÓN DIRECTA. Este plan posiblemente no le permita optar por una REINVERSIÓN DIRECTA si sus distribuciones durante el año son menos de $200.

REINVERSIÓN DIRECTA en una cuenta IRA tradicional. Puede abrir una cuenta IRA tradicional para recibir la reinversión directa. Si decide que se le haga su pago directamente en una cuenta IRA tradicional, póngase en contacto con una entidad patrocinadora de una cuenta IRA (normalmente una institución financiera) para averiguar cómo se hace una reinversión directa en una cuenta IRA tradicional en esa institución. Si no está seguro de cómo invertir su dinero, puede abrir temporalmente una IRA tradicional para recibir el pago. Sin embargo, al elegir una cuenta IRA tradicional, debiera asegurarse de que la cuenta IRA tradicional que elige le permitirá transferir todo o parte de su pago a otra cuenta IRA tradicional en una fecha posterior sin penalizaciones u otras restricciones. Véase la Publicación 590, Planes de Ahorro para la Jubilación, del IRS, para obtener información adicional sobre las cuentas IRA tradicionales (incluidas las limitaciones sobre la frecuencia con que puede usted reinvertir entre cuentas IRA).

REINVERSIÓN DIRECTA en un Plan. Si usted trabaja para un nuevo empleador que posee un plan patronal calificado y desea hacer una reinversión directa en ese plan, pregunte al administrador del plan de ese plan si aceptará su reinversión. Un plan patronal calificado no está legalmente obligado a aceptar una reinversión. Aunque el plan de su nuevo empleador no acepte una reinversión, usted puede optar por una REINVERSIÓN DIRECTA en una cuenta IRA tradicional. Si el plan del empleador acepta su reinversión, el mismo podría poner restricciones en cuanto a las circunstancias en que usted podría recibir más tarde una distribución de la cantidad reinvertida o podría requerir el consenso del cónyuge para cualquier distribución posterior. Consulte con el administrador del plan de dicho plan antes de tomar su decisión.

REINVERSIÓN DIRECTA de una serie de pagos. Si usted recibe un pago que puede reinvertirse en una cuanta IRA tradicional o en un plan patronal calificado que lo acepte y se efectúa en una serie de pagos durante un plazo de menos de 10 años, su opción de hacer o no una REINVERSIÓN DIRECTA para un pago se aplicará a todos los pagos posteriores de la serie hasta que cambie su opción. Tendrá libertad para cambiar su opción respecto a cualquier pago posterior de la serie.

Cambio del tratamiento tributario como resultado de una REINVERSIÓN DIRECTA. El tratamiento tributario de cualquier pago del plan patronal calificado o la cuenta IRA tradicional que recibe su REINVERSIÓN DIRECTA podría ser diferente al que se aplicaría si recibiera su beneficio en una distribución tributable directamente del Plan. Por ejemplo, si usted nació antes del 1 de enero de 1936, podría tener derecho a un tratamiento en forma de prorrateo del impuesto de diez años o como ganancia de capital, como se explicará más adelante. Sin embargo, si ordena que su beneficio se le reinvierta en una anualidad con pago del impuesto diferido de la sección 403(b), un plan 457 gubernamental o una cuenta IRA tradicional en una REINVERSIÓN DIRECTA, su beneficio no podrá ya acogerse a dicho tratamiento tributario especial. Véanse más adelante las secciones tituladas "Impuesto adicional del 10% si usted no ha cumplido 59 años y medio" y "Tratamiento tributario especial si usted nació antes del 1 de enero de 1936".

III. *PAGO HECHO A USTED*

Si su pago puede reinvertirse (véase la Parte I anterior) y éste se le hace en efectivo, entonces estará sujeto a una retención del impuesto federal sobre el ingreso del 20% sobre la parte tributable (y posiblemente también a una retención del impuesto estatal). El impuesto sobre el pago se grava en el año en que lo recibe, a menos que lo reinvierta dentro de un plazo de 60 días en una cuenta IRA tradicional o en un plan patronal calificado que acepte reinversiones. Si no lo reinvierte, podrían aplicarse ciertas reglas tributarias especiales.

Retención del impuesto sobre el ingreso:

Retención obligatoria. Si cualquier parte de su pago puede reinvertirse conforme a lo establecido en la Parte I anterior y usted no opta por hacer una REINVERSIÓN DIRECTA, el Plan estará obligado por ley a retenerle el 20% de la cantidad tributable. Esta cantidad se envía al IRA como retención del impuesto sobre el ingreso. Por ejemplo, si puede reinvertir un pago tributable de $10,000, se le pagará solamente $8,000, porque el Plan tiene que retener $2,000 como impuesto sobre el ingreso. Sin embargo, cuando usted prepare su declaración del impuesto sobre el ingreso para el año, salvo que haga una reinversión dentro de un plazo de 60 días (véase "Opción de reinversión de sesenta días" más adelante), tendrá que declarar la cantidad total de $10,000 como un pago tributable del Plan. Debe declarar los $2,000 como una retención del impuesto y se le acreditará esa cantidad contra cualquier impuesto sobre el ingreso que deba para el año. No se hará ninguna retención del impuesto sobre el ingreso si sus pagos para el año son menos de $200.

Retención voluntaria. Si cualquier parte de su pago es tributable, pero no puede reinvertirse de acuerdo con lo establecido en la Parte I precedente, las reglas sobre la retención obligatoria que se han descrito anteriormente no son aplicables. En tal caso, podría elegir que no se le haga retención sobre esa parte. Si usted no hace nada, se le descontará una cantidad de esa parte de su pago en concepto de retención del impuesto federal sobre el ingreso. Para no optar por la retención, solicite al Administrador del Plan la forma de la opción y la información pertinente.

Opción de reinversión de sesenta días. Si recibe un pago que puede reinvertirse conforme a lo establecido en la Parte I anterior, usted podrá, no obstante, optar por reinvertir todo el pago o parte del mismo en una cuenta IRA tradicional o en un plan patronal calificado que acepte reinversiones. Si decide hacer una reinversión, *tendrá que transferir la cantidad del pago que recibió a una cuenta IRA tradicional o a un plan patronal calificado dentro de un plazo de 60 días a partir de la fecha en que recibió el pago.*

La parte de su pago que se reinvierte no se gravará hasta que usted la saque de la cuenta IRA tradicional o del plan patronal calificado.

Podrá reinvertir hasta el 100% de su pago que pueda reinvertirse conforme a lo dispuesto en la Parte I anterior, incluida una cantidad igual al 20% de la parte tributable que le fue retenida. Si opta por reinvertir el 100%, tendrá que obtener el dinero de otra parte dentro de un plazo de 60 días para contribuir a la cuenta IRA tradicional o al plan patronal calificado para reponer el 20% que se le retuvo. Por otra parte, si reinvierte solamente el 80% de la parte tributable que recibió, tendrá que pagar impuesto sobre el 20% que se le retuvo.

Ejemplo: La parte tributable de su pago que puede reinvertirse de acuerdo con lo establecido en la Parte I anterior es una suma de $10,000 y puede elegir que se le pague a usted. Recibirá $8,000, y $2,000 se enviarán al IRS como retención del impuesto sobre el ingreso. Dentro de un plazo de 60 días de haber recibido los $8,000, usted podrá reinvertir toda la cantidad de $10,000 en una cuenta IRA tradicional o en un plan patronal calificado. Para ello, reinvertirá los $8,000 que recibió del Plan y tendrá que obtener $2,000 de otras fuentes (sus ahorros, un préstamo, etc.). En tal caso, la cantidad total de $10,000 no tributará hasta que la saque de la cuenta IRA tradicional o del plan patronal calificado. Si reinvierte la suma total de los $10,000, cuando presente su declaración del impuesto sobre el ingreso, podría obtener un reembolso de parte o de toda la cantidad de los $2,000 retenidos.

Si, por otro lado, usted reinvierte solamente $8,000, los $2,000 que no reinvirtió tributarán en el año en que se retuvieron. Cuando presente su declaración del impuesto sobre el ingreso, podría obtener un reembolso de parte de los $2,000 que le fueron retenidos. (Sin embargo, cualquier reembolso será probablemente mayor si reinvierte toda la cantidad de los $10,000).

Impuesto adicional del 10% si usted no ha cumplido 59 años y medio". Si recibe un pago antes de cumplir 59 años y medio y no lo reinvierte, entonces, además del impuesto ordinario sobre el ingreso, tendría que pagar un impuesto adicional igual al 10% de la parte tributable del pago. El impuesto adicional del 10% no se aplica generalmente a (1) los pagos que se hacen después de haber cesado usted de trabajar para su empleador en el año o después del año en que cumpla usted 55 años; (2) los pagos que se hacen porque se jubila por incapacidad; (3) los pagos que se hacen como pagos iguales (o casi iguales) durante su vida o expectativa de vida (o durante las vidas y expectativas de vida de usted y su beneficiario); (4) los dividendos pagados en acciones por un plan de compra de acciones para los empleados (ESOP), según se describe en la sección 404(k) del Código Tributario; (5) los pagos que se hacen directamente al gobierno para pagar un gravamen de impuesto federal; (6) los pagos que se hacen a un beneficiario sustituto conforme a una orden judicial de asuntos familiares calificada, o (7) los pagos que no exceden de la cantidad de sus gastos médicos deducibles. Véase la Forma 5329 del IRS para obtener información adicional sobre el impuesto adicional del 10% .

El impuesto adicional del 10% no se aplica a las distribuciones de un plan 457 gubernamental, salvo en la medida en que la distribución sea atribuible a una cantidad que usted reinvirtió en ese plan (ajustada para los rendimientos de la inversión) de otro tipo de plan patronal calificado o IRA. Cualquier cantidad reinvertida de un plan 457 gubernamental en otro tipo de plan patronal calificado o en una cuenta IRA tradicional estará sujeta al impuesto adicional del 10% si se le distribuye antes de cumplir usted los 59 años y medio, a menos que le sea aplicable una de las excepciones.

"*Tratamiento tributario especial si usted nació antes del 1 de enero de 1936*". Si recibe un pago de un plan calificado conforme a la sección 401(a) o un plan de anualidad de la sección 403(a) que puede reinvertirse de acuerdo con la Parte I y no lo reinvierte en una cuenta IRA tradicional o en un plan patronal calificado, el pago tributará en el año que lo recibe. Sin embargo, si el pago se considera una "distribución en una suma global", podría calificarse para un tratamiento tributario especial. (Véase también "Acciones o títulos del empleador" más adelante.) La distribución en una suma global es un pago, dentro de un año, de todo su saldo en el Plan (y en otros planes patronales similares) que es pagadero a su favor después de haber cumplido 59 años y medio o porque ha cesado usted de trabajar para su empleador (o, en el caso de una persona que trabaja por cuenta propia, después de haber usted cumplido 59 años y medio o de haberse declarado incapacitado). Para que un pago pueda tratarse como una distribución en una suma global, usted tendrá que haber participado en el plan cinco años, como mínimo, antes del año en que recibió la distribución. A continuación se describe el tratamiento tributario especial para las distribuciones en una suma global que podría haber a su disposición.

Prorrateo de diez años. Si recibe una distribución en una suma global y nació antes del 1 de enero de 1936, podrá tomar una opción usada una sola vez para calcular el impuesto sobre el pago, utilizando el "prorrateo de 10 años" (utilizando las tasas de impuesto de 1986). El prorrateo de diez años suele reducir el impuesto que usted debe.

Tratamiento como ganancia de capital. Si recibe una distribución en una suma global, nació antes del 1 de enero de 1936 y participó en el Plan antes de 1974, podrá elegir que la parte de su pago atribuible a su participación anterior a 1974 en el Plan le sea tratada para efectos de los impuestos como ganancia de capital a una tasa del 20%.

Hay otras restricciones sobre el tratamiento tributario especial para las distribuciones en una suma global. Por ejemplo, usted puede generalmente optar por este tratamiento tributario especial solamente una vez durante su vida, y la opción se aplica a todas las distribuciones en una suma global que reciba en ese mismo año. Puede no elegir este tratamiento tributario especial si reinvirtió cantidades en ese Plan de un contrato de anualidad con pago del impuesto diferido de la sección 403(b), un plan 457 gubernamental o una cuenta IRA no atribuible originalmente a un plan patronal calificado. Si ha reinvertido anteriormente una distribución de dicho Plan (o de otros

planes patronales similares determinados), no podrá utilizar el tratamiento especial del prorrateo para pagos posteriores del Plan. Si reinvierte su pago en una cuenta IRA tradicional, un plan 457 gubernamental o en una anualidad con pago del impuesto diferido de la sección 403(b), no podrá utilizar el tratamiento tributario especial para pagos posteriores de esa cuenta IRA, plan o anualidad. Asimismo, si reinvierte solamente una parte de su pago en una cuenta IRA tradicional, un plan 457 gubernamental o en una anualidad con pago del impuesto diferido de la sección 403(b), no se podrá aplicar este tratamiento tributario especial al resto del pago. Véase la Forma 4972 del IRS para obtener información adicional sobre las distribuciones en una suma global y cómo puede usted elegir el tratamiento tributario especial.

Acciones o títulos de un plan patronal. Hay una regla especial que se aplica a un pago del Plan que incluye acciones patronales (u otros títulos patronales). Para utilizar esta regla especial, 1) el pago tiene que calificarse como distribución en una suma global, como se ha descrito ya anteriormente, salvo que usted no necesitará cinco años de participación en el plan o 2) las acciones patronales incluidas en el pago deben ser atribuibles a contribuciones del empleado u obrero "después del impuesto", si las hubiera. De acuerdo con esa regla especial, usted puede tener la opción de no pagar impuesto sobre la "valorización no realizada neta" de las acciones hasta que las venda. La valorización no realizada neta es generalmente el incremento del valor de la acción patronal durante el tiempo en que la acción fue poseída por el Plan. Por ejemplo, si la acción patronal fue contribuida a su cuenta del Plan cuando ésta valía $1,000, pero la acción valía $1,200 cuando la recibió, no tendría que pagar impuesto sobre el incremento de valor de $200 hasta que usted venda la acción posteriormente.

Usted podría, en su lugar, optar por hacer que no se aplique la regla especial a la valorización no realizada neta. En tal caso, su valorización no realizada neta se gravará en el año que reciba la acción, a menos que la reinvierta. La acción puede reinvertirse en una cuenta IRA tradicional o en otro plan patronal calificado, bien en forma de una reinversión directa o de una reinversión que haga usted mismo. En general, no podrá ya utilizar la regla especial para la valorización no realizada neta si reinvierte la acción en una cuenta IRA tradicional o en un plan patronal calificado.

Si recibe solamente acciones de un plan patronal en un pago que puede reinvertirse, no se le retendrá ninguna cantidad del pago. Si recibe dinero efectivo u otros bienes que no sean acciones de un plan patronal, y también acciones de un plan patronal, en un pago que puede reinvertirse, la cantidad de la retención del 20% se basará en la cantidad total tributable que se le haya pagado (incluido el valor de las acciones de un plan patronal calculado excluyendo la valorización no realizada neta). Sin embargo, la cantidad retenida se limitará al efectivo o bienes recibidos (excluidas las acciones de un plan patronal) que se le hayan pagado.

Si recibe acciones de un plan patronal en un pago que se considera una distribución en una suma global, se podrá también aplicar el tratamiento tributario especial para las distribuciones en una suma global que se ha descrito anteriormente (como el prorrateo de 10 años). Véase la Forma 4972 del IRS para obtener información adicional sobre estas reglas.

Reembolso de préstamos del Plan. Si su empleo cesa y tiene usted un préstamo pendiente con su Plan, su empleador puede reducir (o "compensar") su saldo en el Plan por la cuantía del préstamo que no haya pagado. La cuantía de la compensación del préstamo se trata como si fuera una distribución que se le hace a usted en el momento de la compensación y tributará, a menos que usted reinvierta una cantidad igual a la cantidad de la compensación de su préstamo en otro plan patronal calificado o en una cuenta IRA tradicional dentro de un plazo de 60 días a partir de la fecha de la compensación. Si la cantidad de la compensación de su préstamo es la única cantidad que usted recibe o se trata como si la hubiera recibido, no se le retendrá ninguna cantidad de ella. Si recibe otros pagos en efectivo o bienes del Plan, la cantidad de retención del 20% se basará en la cantidad total que se le haya pagado, incluida la cantidad de la compensación del préstamo. La cantidad retenida se limitará a la cantidad de otros pagos en efectivos o bienes que se le hayan hecho (que no sean títulos de planes patronales). La cantidad de un préstamo del plan con incumplimiento de pago que se considere una distribución tributable no puede reinvertirse.

IV. *CÓNYUGES SOBREVIVIENTES, BENEFICIARIOS SUSTITUTOS Y OTROS BENEFICIARIOS*

En general, las reglas que se han resumido anteriormente aplicables a los pagos efectuados a los empleados se aplican también a los cónyuges sobrevivientes de los empleados y a los cónyuges o ex cónyuges que son "beneficiarios sustitutos". Usted es un beneficiario sustituto cuando su participación en el Plan se debe a una "orden judicial de asuntos familiares especificada", que es una orden dictada por un tribunal, normalmente en relación con un divorcio o una separación legal.

Si usted es un cónyuge sobreviviente o un beneficiario sustituto, podría optar por un pago que puede reinvertirse, como ya se ha descrito en la Parte I, efectuado en forma de REINVERSIÓN DIRECTA en una cuenta IRA tradicional o un plan patronal calificado o hecho a usted. Si hace que el pago se le haga a usted, puede quedarse con él o reinvertirlo usted mismo en una cuenta IRA tradicional o en un plan patronal calificado. Así, pues, usted tendrá las mismas opciones que las del empleado.

Si es un beneficiario que no sea un cónyuge sobreviviente o un beneficiario sustituto, no podrá optar por una reinversión directa ni reinvertir el pago usted mismo.

Si es un cónyuge sobreviviente, un beneficiario sustituto u otro beneficiario, su pago no estará normalmente sujeto al impuesto adicional del 10% que se ha descrito anteriormente en la Parte III, aunque no haya cumplido los 59½.

Si es un cónyuge sobreviviente, un beneficiario sustituto u otro beneficiario, usted podría utilizar el tratamiento tributario especial para las distribuciones en una suma global y la regla especial para los pagos que incluyen acciones de planes patronales, como ya se ha descrito en la

Parte III. Si recibe un pago por fallecimiento del empleado, usted podría tratar el pago como una distribución en una suma global si el empleado cumple con los requisitos de edad correspondientes, independientemente de si éste participó o no 5 años en el Plan.

CÓMO OBTENER INFORMACIÓN ADICIONAL

Esta notificación ofrece solamente un resumen de las reglas tributarias federales (no estatales o municipales) que podrían aplicarse a su pago. Las reglas que se han descrito anteriormente son complejas y contienen muchas condiciones y excepciones que no se han incluido en esta notificación. Por lo tanto, debiera consultar con el Administrador del Plan o con un asesor de impuestos profesional antes de obtener un pago de sus beneficios del Plan. Puede también encontrar información más específica sobre el tratamiento fiscal de los pagos percibidos de planes patronales calificados en la Publicación 575, Ingresos de Pensiones y Anualidades, y la Publicación 590, Planes de Ahorro para la Jubilación, del IRS. Estas publicaciones se pueden obtener en su oficina local del IRS, a través del sitio web de la Internet en la dirección *www.irs.gov* o llamando al número 1–800–TAX-FORM (1–800–829–3676).

EXPLICACIÓN DEL CONCEPTO DE REFUGIO TRIBUTARIO EN LOS PLANES 457 GUBERNAMENTALES

NOTIFICACIÓN TRIBUTARIA ESPECIAL SOBRE LOS PAGOS DE PLANES

En esta notificación se explica la forma en que usted puede continuar aplazando el pago del impuesto federal sobre el ingreso en sus ahorros de la jubilación en el [INSERTAR AQUÍ EL NOMBRE DEL PLAN] (en adelante denominado el "Plan"). La notificación contiene también una información importante que usted debe conocer antes de decidir cómo va a recibir los beneficios o pagos de su Plan.

Esta notificación se la envía a usted [INSERTAR AQUÍ EL NOMBRE DEL ADMINISTRADOR DEL PLAN] (en adelante denominado el "Administrador del Plan"), porque toda la cantidad o parte del pago que va usted a recibir dentro de poco del Plan podría cumplir con los requisitos establecidos para una reinversión por usted o su Administrador del Plan en una cuenta IRA tradicional o en un plan patronal calificado. Una reinversión es un pago o transferencia efectuado por usted o el Administrador del Plan de todo o parte de su beneficio a otro plan o a una cuenta IRA que le permite continuar posponiendo el pago del impuesto sobre ese beneficio hasta que se le pague. Su pago no puede reinvertirse en una cuenta Roth IRA, en una cuenta SIMPLE IRA ni en una cuenta de ahorro para la educación Coverdell Education Savings Account (anteriormente conocida como cuenta IRA para educación). Un "plan patronal calificado" consiste en un plan que reúne los requisitos legales establecidos en la sección 401(a) del Código Tributario, que comprende los planes siguientes: plan 401(k) del empleador, plan de participación en los beneficios, plan de beneficios definidos, plan de acciones gratuitas y plan de contribución dineraria patronal al fondo de pensiones; un plan de anualidad de la sección 403(a), una anualidad con pago del impuesto diferido de la sección 403(b), y un plan calificado de la sección 457(b) mantenido por un empleador del gobierno (plan 457 gubernamental). El Plan aquí es un plan 457 gubernamental.

Un plan patronal calificado no está legalmente obligado a aceptar una reinversión. Antes de decidir reinvertir su pago en otro plan patronal, deberá averiguar si el plan acepta reinversiones y, en caso afirmativo, los tipos de distribuciones que acepta como reinversión. Deberá informarse también sobre los documentos requeridos que han de llenarse para que el plan receptor acepte una reinversión. Aunque un plan acepte reinversiones, podría no aceptar reinversiones de ciertos tipos de distribuciones. Cuando éste sea el caso, usted podría en su lugar, si lo desea, reinvertir su distribución en una cuenta IRA tradicional o bien dividir la cantidad de la reinversión entre el plan patronal en el que va a participar y una cuenta IRA tradicional. Si un plan patronal acepta su reinversión, el mismo podría limitar las distribuciones posteriores de la cantidad de reinversión o requerir el consentimiento de su cónyuge para cualquier distribución posterior. Una distribución posterior del plan que acepta su reinversión podría estar también sujeta a un tratamiento tributario distinto al de las distribuciones de este Plan. Consulte con el administrador del plan que va a recibir su reinversión antes de hacer la reinversión.

Si tiene usted algunas preguntas que hacer después de leer esta notificación, puede ponerse en contacto con el administrador de su plan [INSERTAR AQUÍ EL NÚMERO DE TELÉFONO U OTRA INFORMACIÓN DE CONTACTO].

RESUMEN

Hay dos maneras en que usted podría recibir un pago del Plan que reúne los requisitos exigidos para una reinversión:

(1) Ciertos pagos pueden hacerse directamente a una cuenta IRA tradicional que usted tenga o a un plan patronal calificado que lo aceptará y mantendrá para su beneficio ("REINVERSIÓN DIRECTA"). O

(2) Pago HECHO A USTED.

Si usted opta por una REINVERSIÓN DIRECTA:

- Su pago no tributará en el año actual ni se le hará ninguna retención del impuesto sobre el ingreso.
- Usted decide si su pago se hará directamente a su cuenta IRA tradicional o a un plan patronal calificado que acepta su reinversión. Su pago no puede reinvertirse en una cuenta Roth IRA, una cuenta SIMPLE IRA ni en una cuenta de ahorro para educación Coverdell Education Savings Account porque éstas no son cuentas IRA tradicionales.
- La parte tributable de su pago se gravará más tarde cuando la saque de su cuenta IRA tradicional o del plan patronal calificado. Dependiendo del tipo de plan de que se trate, la distribución posterior podría estar sujeta a un tratamiento tributario diferente al que se aplicaría si usted recibiera una distribución tributable de este Plan.

Si opta por un pago HECHO A USTED del Plan que reúne los requisitos exigidos para una reinversión:

- Recibirá solamente el 80% de la cantidad tributable del pago, porque

el Administrador del Plan tiene que retener el 20% de esa cantidad y enviarla al IRS como retención del impuesto sobre el ingreso para ser acreditada contra sus impuestos.

- La cantidad tributable de su pago se gravará en el año actual, a menos que la reinvierta.
- Usted puede reinvertir todo o parte del pago, transfiriéndolo a su cuenta IRA tradicional o a un plan patronal calificado que acepte su reinversión dentro de un plazo de 60 días a partir del recibo del pago. La cantidad reinvertida no tributará hasta que usted no la saque de su cuenta IRA tradicional o del plan patronal calificado.
- Si usted desea reinvertir el 100% del pago en una cuenta IRA tradicional o en un plan patronal calificado, *tendrá que obtener el dinero de otra fuente para reponer el 20% de la parte tributable que se le retuvo*. Si reinvierte solamente el 80% del pago que recibió, tendrá que pagar impuestos sobre el 20% que se le retuvo y no se reinvierte.

Su Derecho a Renunciar al Plazo de Notificación de 30 Días. En general, no podrá hacerse una reinversión directa ni un pago del plan hasta 30 días, como mínimo, después de haber recibido esta notificación. Por lo tanto, después de recibir esta notificación, tendrá un plazo, como mínimo, de 30 días para pensar si va o no a reinvertir directamente su retiro. Si no quiere esperar hasta que finalice ese plazo de notificación de 30 días para la tramitación de su opción, puede renunciar al mismo, haciendo una elección afirmativa e indicando si desea o no una reinversión directa. Su retiro será entonces tramitado de acuerdo con su opción lo antes posible después de recibirla el Administrador del Plan.

MÁS INFORMACIÓN

I. *PAGOS QUE PUEDEN Y QUE NO PUEDEN REINVERTIRSE*

Los pagos recibidos del Plan pueden ser “distribuciones de reinversión calificadas”, o sea, que pueden reinvertirse en una cuenta IRA tradicional o en un plan patronal calificado que acepte reinversiones. Los pagos de un plan no pueden reinvertirse en una cuenta Roth IRA, una cuenta SIMPLE IRA ni en una cuenta de ahorro para educación Coverdell Education Savings Account. El administrador de su Plan podrá decirle qué parte de su pago es una distribución de reinversión calificada.

Los tipos de pagos que se indican a continuación *no pueden* reinvertirse:

Pagos espaciados en períodos largos de tiempo. No podrá reinvertir un pago si éste forma parte de una serie de pagos iguales (o casi iguales) que se hacen al menos una vez al año y que durarán:

- Toda su vida (o un período basado en su expectativa de vida). O
- Toda su vida y toda la vida de su beneficiario (o un período basado en las expectativas de vida de ambos). O
- Un período de 10 o más años.

Pagos mínimos requeridos. A partir de la fecha en que cumpla 70 años y medio o se jubile, la fecha que ocurra más tarde, cierta cantidad de su pago no podrá reinvertirse, porque existe un “pago mínimo requerido” que deberá hacérsele a usted.

Distribuciones por casos de emergencia imprevistos. Una distribución por un caso de emergencia imprevisto no puede reinvertirse.

Distribuciones de contribuciones excesivas. Una distribución que se hace por que se han excedido los límites legales establecidos para ciertas contribuciones no puede reinvertirse.

Préstamos tratados como distribuciones. La cuantía de un préstamo con cargo a un plan considerada una distribución tributable por incumplimiento de pago no puede reinvertirse. Sin embargo, una cuantía compensatoria del préstamo puede reinvertirse, como se explicará en la Parte III más adelante. Pregunte al Administrador del Plan de dicho Plan si la distribución de su préstamo cumple con los requisitos exigidos para tratarlo como reinversión.

El Administrador del Plan de dicho Plan podrá indicarle si su pago incluye cantidades que no pueden reinvertirse.

II. *REINVERSIÓN DIRECTA*

UNA REINVERSIÓN DIRECTA es un pago directo de la cantidad de sus beneficios recibidos del Plan en una cuenta IRA tradicional o en un plan patronal calificado que lo acepte. Usted puede optar por una REINVERSIÓN DIRECTA de todo o de cualquier parte de su pago que sea una distribución de reinversión calificada, según se ha descrito anteriormente en la Parte I. Cualquier parte tributable de su pago de la que opte por una REINVERSIÓN DIRECTA se gravará más tarde cuando la saque de su cuenta IRA tradicional o del plan patronal calificado. Además, no se requerirá hacer ninguna retención del impuesto sobre el ingreso en ninguna parte tributable de sus beneficios del Plan de la que opte por una REINVERSIÓN DIRECTA. Este plan posiblemente no le permita optar por una REINVERSIÓN DIRECTA si sus distribuciones durante el año son menos de $200.

REINVERSIÓN DIRECTA en una cuenta IRA tradicional. Puede abrir una cuenta IRA tradicional para recibir la reinversión directa. Si decide que se le haga su pago directamente en una cuenta IRA tradicional, póngase en contacto con una entidad patrocinadora de una cuenta

IRA (normalmente una institución financiera) para averiguar cómo se hace una reinversión directa en una cuenta IRA tradicional en esa institución. Si no está seguro de cómo invertir su dinero, puede abrir temporalmente una IRA tradicional para recibir el pago. Sin embargo, al elegir una cuenta IRA tradicional, debiera asegurarse de que la cuenta IRA tradicional que elige le permitirá transferir todo o parte de su pago a otra cuenta IRA tradicional en una fecha posterior sin penalizaciones u otras restricciones. Véase la Publicación 590, Planes de Ahorro para la Jubilación, del IRS, para obtener información adicional sobre las cuentas IRA tradicionales (incluidas las limitaciones sobre la frecuencia con que puede usted reinvertir entre cuentas IRA).

REINVERSIÓN DIRECTA en un Plan. Si usted trabaja para un nuevo empleador que posee un plan patronal calificado y desea hacer una reinversión directa en ese plan, pregunte al administrador del plan de ese plan si aceptará su reinversión. Un plan patronal calificado no está legalmente obligado a aceptar una reinversión. Aunque el plan de su nuevo empleador no acepte una reinversión, usted puede optar por una REINVERSIÓN DIRECTA en una cuenta IRA tradicional. Si el plan del empleador acepta su reinversión, el mismo podría poner restricciones en cuanto a las circunstancias en que usted podría recibir más tarde una distribución de la cantidad reinvertida o podría requerir el consenso del cónyuge para cualquier distribución posterior. Consulte con el administrador del plan de dicho plan antes de tomar su decisión.

REINVERSIÓN DIRECTA de una serie de pagos. Si usted recibe un pago que puede reinvertirse en una cuanta IRA tradicional o en un plan patronal calificado que lo acepte y se efectúa en una serie de pagos durante un plazo de menos de 10 años, su opción de hacer o no una REINVERSIÓN DIRECTA para un pago se aplicará a todos los pagos posteriores de la serie hasta que cambie su opción. Tendrá libertad para cambiar su opción respecto a cualquier pago posterior de la serie.

Cambio del tratamiento tributario como resultado de una REINVERSIÓN DIRECTA. El tratamiento tributario de cualquier pago del plan patronal calificado o la cuenta IRA tradicional que recibe su REINVERSIÓN DIRECTA podría ser diferente al que se aplicaría si recibiera su beneficio en una distribución tributable directamente del Plan. Véase más adelante la sección titulada "Impuesto adicional del 10% que puede aplicarse a ciertas distribuciones".

III. *PAGO HECHO A USTED*

Si su pago puede reinvertirse (véase la Parte I anterior) y éste se le hace en efectivo, entonces estará sujeto a una retención del impuesto federal sobre el ingreso del 20% sobre la parte tributable (y posiblemente también a una retención del impuesto estatal). El impuesto sobre el pago se grava en el año en que lo recibe, a menos que lo reinvierta dentro de un plazo de 60 días en una cuenta IRA tradicional o en un plan patronal calificado que acepte reinversiones. Si no lo reinvierte, podrían aplicarse ciertas reglas tributarias especiales.

Retención del impuesto sobre el ingreso:

Retención obligatoria. Si cualquier parte de su pago puede reinvertirse conforme a lo establecido en la Parte I anterior y usted no opta por hacer una REINVERSIÓN DIRECTA, el Plan estará obligado por ley a retenerle el 20% de la cantidad tributable. Esta cantidad se envía al IRA como retención del impuesto federal sobre el ingreso. Por ejemplo, si puede reinvertir un pago tributable de $10,000, se le pagará solamente $8,000, porque el Plan tiene que retener $2,000 como impuesto sobre el ingreso. Sin embargo, cuando usted prepare su declaración del impuesto sobre el ingreso para el año, salvo que haga una reinversión dentro de un plazo de 60 días (véase "Opción de reinversión de sesenta días" más adelante), tendrá que declarar la cantidad total de $10,000 como un pago tributable del Plan. Debe declarar los $2,000 como una retención del impuesto y se le acreditará esa cantidad contra cualquier impuesto sobre el ingreso que deba para el año. No se hará ninguna retención del impuesto sobre el ingreso si sus pagos para el año son menos de $200.

Retención voluntaria. Si cualquier parte de su pago es tributable, pero no puede reinvertirse de acuerdo con lo establecido en la Parte I precedente, las reglas sobre la retención obligatoria que se han descrito anteriormente no son aplicables. En tal caso, podría elegir que no se le haga retención sobre esa parte. Si usted no hace nada, se le descontará una cantidad de esa parte de su pago en concepto de retención del impuesto federal sobre el ingreso. Para no optar por la retención, solicite al Administrador del Plan la forma de la opción y la información pertinente.

Opción de reinversión de sesenta días. Si recibe un pago que puede reinvertirse conforme a lo establecido en la Parte I anterior, usted podrá, no obstante, optar por reinvertir todo el pago o parte del mismo en una cuenta IRA tradicional o en un plan patronal calificado que acepte reinversiones. Si decide hacer una reinversión, *tendrá que transferir la cantidad del pago que recibió a una cuenta IRA tradicional o a un plan patronal calificado dentro de un plazo de 60 días a partir de la fecha en que recibió el pago.* La parte de su pago que se reinvierte no se gravará hasta que usted la saque de la cuenta IRA tradicional o del plan patronal calificado.

Podrá reinvertir hasta el 100% de su pago que pueda reinvertirse conforme a lo dispuesto en la Parte I anterior, incluida una cantidad igual al 20% de la parte tributable que le fue retenida. Si opta por reinvertir el 100% , tendrá que obtener el dinero de otra parte dentro de un plazo de 60 días para contribuir a la cuenta IRA tradicional o al plan patronal calificado para reponer el 20% que se le retuvo. Por otra parte, si reinvierte solamente el 80% de la parte tributable que recibió, tendrá que pagar impuesto sobre el 20% que se le retuvo.

> *Ejemplo*: Su pago que puede reinvertirse de acuerdo con lo establecido en la Parte I anterior es una suma de $10,000 y puede elegir que se le pague a usted. Recibirá $8,000, y $2,000 se enviarán al IRS como retención del impuesto sobre el ingreso. Dentro de un plazo de 60 días de haber recibido los $8,000, usted podrá reinvertir toda la cantidad de $10,000 en una cuenta IRA tradicional o en un plan patronal calificado. Para ello, reinvertirá los $8,000 que recibió del Plan y tendrá que obtener $2,000 de otras fuentes (sus ahorros, un préstamo, etc.). En tal

caso, la cantidad total de $10,000 no tributará hasta que la saque de la cuenta IRA tradicional o del plan patronal calificado. Si reinvierte la suma total de los $10,000, cuando presente su declaración del impuesto sobre el ingreso, podría obtener un reembolso de parte o de toda la cantidad de los $2,000 retenidos.

Si, por otro lado, usted reinvierte solamente $8,000, los $2,000 que no reinvirtió tributarán en el año en que se retuvieron. Cuando presente su declaración del impuesto sobre el ingreso, podría obtener un reembolso de parte de los $2,000 que le fueron retenidos. (Sin embargo, cualquier reembolso será probablemente mayor si reinvierte toda la cantidad de los $10,000).

Impuesto adicional del 10% que puede aplicarse a ciertas distribuciones. Las distribuciones que se reciben de este Plan no están generalmente sujetas al impuesto adicional del 10% que se aplica a distribuciones de otros tipos de planes antes de cumplir 59 años y medio. Sin embargo, cualquier distribución que sea atribuible a una cantidad que usted reinvirtió en el Plan (ajustada para los rendimientos de la inversión) de otro tipo de plan patronal calificado o de una cuenta IRA estará sujeta al impuesto adicional del 10% si se le distribuye antes de cumplir usted los 59 años y medio, a menos que le sea aplicable una de las excepciones.

Las excepciones al impuesto adicional del 10% son generalmente (1) los pagos que se hacen como pagos iguales (o casi iguales) durante su vida o expectativa de vida (o durante las vidas y expectativas de vida de usted y su beneficiario); (2) los pagos que se hacen de un plan patronal calificado después de haber cesado usted de trabajar para su empleador en el año o después del año en que cumpla usted 55 años; (3) los pagos que se hacen porque se jubila por incapacidad; (4) los pagos que se hacen directamente al gobierno para pagar un gravamen de impuesto federal; (5) los pagos que se hacen a un beneficiario sustituto conforme a una orden judicial de asuntos familiares calificada, o (6) los pagos que no exceden de la cantidad de sus gastos médicos deducibles. Estas excepciones podrían ser diferentes para las distribuciones de una cuenta IRA tradicional. Véase la Forma 5329 del IRS para obtener información adicional sobre el impuesto adicional del 10%.

El impuesto adicional del 10% no se aplica a las distribuciones del Plan o de cualquier otro plan 457 gubernamental, salvo en la medida en que la distribución sea atribuible a una cantidad que usted reinvirtió en el plan 457 gubernamental (ajustada para los rendimientos de la inversión) de otro tipo de plan patronal calificado o de una cuenta IRA.

Asimismo, cualquier cantidad reinvertida del Plan en cualquier otro tipo de plan patronal calificado o en una cuenta IRA tradicional estará sujeta al impuesto adicional del 10% si se le distribuye antes de cumplir usted los 59 años y medio, a menos que le sea aplicable una de las excepciones.

Reembolso de préstamos del Plan. Si su empleo cesa y tiene usted un préstamo pendiente con su Plan, su empleador puede reducir (o "compensar") su saldo en el Plan por la cuantía del préstamo que no haya pagado. La cuantía de la compensación del préstamo se trata como si fuera una distribución que se le hace a usted en el momento de la compensación y tributará, a menos que usted reinvierta una cantidad igual a la cantidad de la compensación de su préstamo en otro plan patronal calificado o en una cuenta IRA tradicional dentro de un plazo de 60 días a partir de la fecha de la compensación. Si la cantidad de la compensación de su préstamo es la única cantidad que usted recibe o se trata como si la hubiera recibido, no se le retendrá ninguna cantidad de ella. Si recibe otros pagos en efectivo o bienes del Plan, la cantidad de retención del 20% se basará en la cantidad total que se le haya pagado, incluida la cantidad de la compensación del préstamo. La cantidad retenida se limitará a la cantidad de otros pagos en efectivos o bienes que se le hayan hecho. La cantidad de un préstamo del plan con incumplimiento de pago que se considere una distribución tributable no puede reinvertirse.

IV. *CÓNYUGES SOBREVIVIENTES, BENEFICIARIOS SUSTITUTOS Y OTROS BENEFICIARIOS*

En general, las reglas que se han resumido anteriormente aplicables a los pagos efectuados a los empleados se aplican también a los cónyuges sobrevivientes de los empleados y a los cónyuges o ex cónyuges que son "beneficiarios sustitutos". Usted es un beneficiario sustituto cuando su participación en el Plan se debe a una "orden judicial de asuntos familiares especificada", que es una orden dictada por un tribunal, normalmente en relación con un divorcio o una separación legal.

Si usted es un cónyuge sobreviviente o un beneficiario sustituto, podría optar por un pago que puede reinvertirse, como ya se ha descrito en la Parte I, efectuado en forma de REINVERSIÓN DIRECTA en una cuenta IRA tradicional o en un plan patronal calificado o hecho a usted. Si hace que el pago se le haga a usted, puede quedarse con él o reinvertirlo usted mismo en una cuenta IRA tradicional o en un plan patronal calificado. Así, pues, usted tendrá las mismas opciones que las del empleado.

Si es un beneficiario que no sea un cónyuge sobreviviente o un beneficiario sustituto, no podrá optar por una reinversión directa ni reinvertir el pago usted mismo.

Si es un cónyuge sobreviviente, un beneficiario sustituto u otro beneficiario, su pago no estará normalmente sujeto al impuesto adicional del 10% que se ha descrito anteriormente en la Parte III, aunque no haya cumplido los 59½.

CÓMO OBTENER INFORMACIÓN ADICIONAL

Esta notificación ofrece solamente un resumen de las reglas tributarias federales (no estatales o municipales) que podrían aplicarse a su pago. Las reglas que se han descrito anteriormente son complejas y contienen muchas condiciones y excepciones que no se han incluido en esta notificación. Por lo tanto, debiera consultar con el Administrador del Plan o con un asesor de impuestos profesional antes de obtener un pago de sus beneficios del Plan. Puede también encontrar información más específica sobre el tratamiento fiscal de los pagos percibidos de planes patronales calificados en la Publicación 575, Ingresos de Pensiones y Anualidades, y la Publicación 590, Planes de

Ahorro para la Jubilación, del IRS. Estas publicaciones se pueden obtener en su oficina local del IRS, a través del sitio web de la Internet en la dirección *www.irs.gov* o llamando al número 1–800–TAX-FORM (1–800–829–3676).

Comments Requested on Possible Amendments to Regulations Governing Chapter 42 Excise Taxes

Announcement 2002–47

The purpose of this announcement is to solicit comments addressing whether several regulations under Chapter 42 should be revised with respect to excise taxes imposed on foundation and organization managers to conform to recently-issued final regulations under section 4958 of the Internal Revenue Code (T.D. 8978, 67 Fed. Reg. 3076; 2002–7 I.R.B. 500). Section 4958 imposes taxes on any transaction that provides excess economic benefits to a person in a position to exercise substantial influence over the affairs of a public charity or a social welfare organization. Under section 4958, taxes are imposed both on the disqualified person who benefits from an excess benefit transaction and any organization manager who knowingly participates in an excess benefit transaction, unless the participation is not willful and is due to reasonable cause. The structure of these section 4958 taxes is similar to excise taxes imposed under Chapter 42 on certain transactions involving private foundations.

The final regulations under section 4958 published in January 2002 provide that an organization manager's participation in an excess benefit transaction will ordinarily not be considered knowing to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise. For this purpose, appropriate professionals are legal counsel (including in-house counsel), certified public accountants or accounting firms with expertise regarding the relevant tax law matters, and independent valuation experts who meet specified requirements. The requirements for appropriate valuation experts are modeled after the section 170 regulations that define *qualified appraisers* for charitable deduction purposes. Under the section 4958 regulations, the valuation experts must hold themselves out to the public as appraisers or compensation consultants; perform the relevant valuations on a regular basis; be qualified to make valuations of the type of property or services being valued; and include in the written opinion a certification that they meet the preceding requirements. See Treas. Reg. § 53.4958–1(d)(4)(iii). Organization managers may seek the opinion of such an expert to help determine whether the economic benefit provided to a disqualified person in a particular transaction represents fair market value (or reasonable compensation).

Like section 4958, sections 4941 (taxes on private foundation self-dealing), 4944 (taxes on investments which jeopardize a private foundation's exempt purposes), 4945 (taxes on taxable expenditures by private foundations), and 4955 (taxes on political expenditures of section 501(c)(3) organizations) also impose excise taxes on foundation managers or organization managers who knowingly participate in transactions prohibited under those sections, unless the participation is not willful and is due to reasonable cause. The regulations under each section contain a safe harbor for managers who disclose the factual situation to legal counsel and rely on a reasoned written legal opinion that the particular transaction is not a prohibited transaction. In such cases, the participation of the manager will not ordinarily be considered "knowing" or "willful", and will ordinarily be considered "due to reasonable cause". See Treas. Reg. § 53.4941(a)–1(b)(6); § 53.4944–1(b)(2)(v); § 53.4945–1(a)(2)(vi); § 53.4955–1(b)(7). Treasury Regulation § 53.4944–1(b)(2)(v) provides an additional safe harbor with respect to taxes on jeopardizing investments, where the foundation manager makes full disclosure to a qualified investment counsel and relies on the advice of such counsel. In that instance, the advice must be derived in a manner consistent with generally accepted practices of persons who are qualified investment counsel, and the opinion that a particular investment will provide for the long and short term financial needs of the foundation must be expressed in writing. Treas. Reg. § 53.4944–1(b)(2)(v).

In connection with the section 4958 regulation project, some commentators suggested that the "advice of counsel" safe harbors contained in regulations under section 4941 (self-dealing) and section 4945 (taxable expenditures) be expanded to parallel the safe harbor for reliance on professional advice contained in the section 4958 regulations. Like section 4958, both sections 4941 and 4945 raise issues relating to the reasonableness of compensation.

Under section 4941, taxes are imposed on acts of self-dealing between a private foundation and its disqualified persons. Although most transactions between a private foundation and its disqualified persons are absolutely prohibited, section 4941 provides an exception for the payment of compensation for personal services that are reasonable and necessary to the foundation's exempt purposes, if the compensation is not excessive. See section 4941(d)(2)(E); Treas. Reg. § 53.4941–3(c)(1).

Section 4945 imposes taxes on taxable expenditures by private foundations, including any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B) (which lists exempt purposes of section 501(c)(3) organizations). Reasonable compensation may be an issue under section 4945 in connection with the standards for permitted administrative expenses. See Treas. Reg. § 53.4945–6(b).

By contrast, section 4944 (jeopardizing investments) and section 4955 (political expenditures) do not involve fair market value or reasonable compensation issues.

The section 4958 regulation project did not undertake any revisions to the advice of counsel safe harbors in other regulations under chapter 42. At this time, the IRS and the Treasury Department request comments on the issue of whether conforming revisions to the rules contained in the section 4958 regulations are appropriate or advisable in the case of any or all of the chapter 42 regulations mentioned above. Please send your comments addressing this issue, as well as comments addressing other areas of

Chapter 42 regulations that may need updating, to the following address by August 6, 2002, referencing Announcement 2002–47:

Internal Revenue Service
CC:ITA:RU, Room 5228
1111 Constitution Ave., N.W.
Washington, DC 20224

The principal author of this announcement is Phyllis D. Haney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this announcement, contact Phyllis D. Haney at (202) 622–4290 (not a toll-free call).

Foundations Status of Certain Organizations

Announcement 2002–50

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

55 Whipple Street Housing Development Fund, Brooklyn, NY
Adult Care Philanthropic Corporation, Roseburg, OR
African-Americans With Disabilities, Wilkinsburg, PA
Algonquin Casino Management, Inc., Springfield, MA
All Children's Assistance Fund, Tustin, CA
All-Together, Inc., Westborough, MA
Alliance for Recovery, Seattle, WA
American Association Affirmative Action Educational Foundation, Indianapolis, IN
American Disabled and Senior Citizens, Inc., Shawnee Mission, KS
American Friends of Manchelay Torah, Inc., Chicago, IL
American Indian Festival, Inc., Cleveland, OH
American Museum of Asmat Art, St. Paul, MN
Amish Innerlight Ministries, Sugar Creek, OH
Andre Sobel River of Life Foundation, Beverly Hills, CA
Animal Refuge Keepers, Inc., North Augusta, SC
ARC Community Housing Opportunities, Inc., Manville, NJ
Artists Collaborative, Minneapolis, MN
Association of Skateboarders in Hawaii, Kailua, HI
August Ensemble Theatre, Inc., River Forest, IL
Baldwinsville Masonic Historical Society, Baldwinsville, NY
Behavioral Health Improvement and Developmental Assistance, Tucson, AZ
B G C, Inc., Brentwood, TN
Big E. Elvin Hayes Foundation, Crosby, TX
Brunswick Trenton Housing Corporation, Clinton, NJ
California Association of American Physicians & Surgeons Educational, Torrance, CA
Caring for the Hills, Chino Hills, CA
Carmelites of the Sacred Heart and the Immaculate Heart, Steubenville, OH
Carroll Community Development Association, Inc., Lakeland, FL
Cavaliers Booster Club, Inc., Cherry Hill, NJ
Center for Intercultural Harmony, Minneapolis, MN
Chance Connection, Las Vegas, NV
Charlotte Dare Advisory Board, Charlotte, MI
Chestertown Housing Foundation, Inc., Chestertown, MD
Chestnut Knolls Aviation Foundation, Inc., London, KY
Chicago Endowment for the Arts, Chicago, IL
Chicago Fine Arts Society, Chicago, IL
Child and Adult Development Center of Houston, Inc., Houston, TX
Children's Aids Foundation, Inc., Binghamton, NY
Childrens Health Foundation, Inc., Beachwood, NJ
Childrens Place Housing Corporation-Childrens Place Association, Chicago, IL
Chillicothe-Ross Community Foundation, Inc., Chillicothe, OH
Cincinnati Consortium for Family Development, Inc., Cincinnati, OH
Cleveland Club of the National Association of Negro Business & Prof., Shaker Heights, OH
Community Housing Corporation, Kamuela, HI
Community Resource and Development Co., Naperville, IL
Community Youth Home Corp. of Forsyth County Mental Health, Raleigh, NC
Comprehensive Innovations Institute, Tampa, FL
Computer Programming Institute, Bedminster, NJ
Consumers Mental Health Services of Ashtabula County, Inc., Ashtabula, OH
Core Heights, Rapid City, SD
Coronado Teen Club, Inc., Coronado, CA
Corporation for Public Information, Tallmadge, OH
Crime Victims Foundation, Inc., Temple City, CA
Dance Educators Coalition of Minn., St. Paul, MN
Deixis Publishing Foundation, Inc., Pittsburgh, PA
Depressive and Manic Depressive Association of the Leigh Valley, Allentown, PA
Detweiler Corporation, Clifton Park, NY
Dilley Community Assistance Corporation, Dilley, TX
District 34 Educational Foundation, Antioch, IL
Donald J. Doody Foundation, Hinsdale, IL
Dover Exchange Club Childrens Foundation, Dover, OH
Dyna-Tek Corporation International, Fresno, CA
E.J. Morris Senior Citizen Community Outreach Center, Inc., New Orleans, LA
East Orange L.L. Sports, Inc. East Orange, NJ
Ella and Robert Ridley Scholarship Foundation, Inc., Winston-Salem, NC

Empowerment Foundation,
Memphis, TN
Enchantment Productions, Inc.,
Wrightwood, CA
Fallbrook Chorale, Fallbrook, CA
Family Learning Tree, Inc., Decatur, GA
Feather, Riverside, CA
Flare, Inc., Flemington, NJ
FLS, Inc., Laurens, SC
Forest Meadows East Resident
Management Corp., Jacksonville, FL
Fort Pocahontas, Ltd., Charles City, VA
Foundation for Independent American
Schools World Wide, Evanston, IL
Freedom Educational Foundation,
Hudsonville, MI
Friends of Arts Education,
Golden Valley, MN
Friends of Historic New Salem, Inc.,
New Salem, MA
Friends of Joseph & Sarah Levy Senior
Center, Bolingbrook, IL
Friends of Oyler Foundation,
Cincinnati, OH
Friends of the James R. Leonard
Community Center, Port Huron, MI
Friends of the Madison School Forest,
Inc., Madison, WI
Generations Youth and Family Services,
Flint, MI
Genesee Oneida Housing Opportunities,
Utica, NY
George Cook Jr. Memorial Supplemental
Educational Library Facility,
Philadelphia, PA
Glencoe Educational Foundation,
Glencoe, IL
Glendale Eruv, Inc., Glendale, WI
Global Technology Exchange
Foundation, Incorporated,
Pennington, NJ
Good News Fellowship, Ketchikan, AK
Grafton Improvement Foundation, Inc.,
Grafton, WI
Greater Princeton Steinway Society, Inc.,
Princeton, NJ
Green Mountain Foundation,
Houston, TX
Hand-N-Hand Creations, Inc.,
Binghamton, NY
Harrisburg Mayors Commission on
Literacy, Harrisburg, PA
Hemophilia Outreach of Wisconsin, Inc.,
Green Bay, WI
Heritage House Group Home,
Columbus, OH
Highland Rim Rural Housing Assistance,
McMinnville, TN
Holland Public Schools-Holland Band
Parents Association, Holland, MI
Homeless Care Foundation, Inc.,
Feasterville, PA
Holmes Counseling Center,
Carbondale, IL
Hoot Owl Servants Corporation,
Spokane, WA
Hope House, Chicago, IL
Hopewell Valley Soccer Club,
Pennington, NJ
Hudson Consulting for Social Services,
Inc., North Bergen, NJ
Huntington Community Strings, Inc.,
Huntington, IN
Institute of Alternative Healing,
Pacific Palisades, CA
Institute of World Traditional Medicine,
San Francisco, CA
International Center for Law Trade and
Diplomacy, Inc., Rye Brook, NY
International Foundation for Mental
Health and Neurosciences, Inc.,
Potomac, MD
Interpreters of Southern California, Inc.,
Riverside, CA
Irish-American Heritage Foundation of
Central New York, Inc., Syracuse, NY
Jackson Community Services,
Chicago, IL
Job Connection, Inc., Whittier, CA
John J. Wagner Ministries, Inc.,
Cooper City, FL
Jubilee Foundation, Prescott, WA
Just for Kids Education Foundation,
Bensalem, Pa
Kankakee Track Club, Kankakee, IL
Kevin J. Lehnert Scholarship Trust Fund,
Crestwood, IL
Kick-Off, Palmdale, CA
Kids Citizenship Foundation,
Chicago, IL
Kids Help Foundation, Schaumburg, IL
Kids Voting Michigan, Detroit, MI
Kingdom Harvest Ministries,
Escondido, CA
Kiwanis Foundation of Table Rock,
Central Point, OR
Kora Filmworks, Berkeley, CA
La Crescent Foundation, Inc.,
La Crescent, MN
Lady of Grace Room & Board,
Riverside, CA
Lakota Foundation, W. Chester, OH
Lao Parent-Student-Teacher Association,
San Diego, CA
Laurel Highlands Academic Foundation,
Uniontown, PA
Learning Immune Function
Enchancement Foundation,
San Francisco, CA
Lifecircles Unlimited, Inc.,
Granada Hills, CA
Lolly Cohen Foundation, Inc.,
Virginia Beach, VA
Maryland Educational Media
Organization, Inc., Queenstown, MD
Meals on Wheels Fund, Inc.,
Madison, WI
Medical and Scientific Information
Online, Inc., Indianapolis, IN
Methuen Community Television Corp.,
Methuen, MA
Michael P. Corrigan Memorial
Scholarship Fund, Poughkeepsie, NY
Milwaukee Concert Band, Inc.,
Elm Grove, WI
Minnesota Chapter Federal Bar
Association Foundation,
Minneapolis, MN
Minuteman Institute for National
Defense Studies, Alexandria, VA
Mississippi Union Club USA,
Incorporated, Indianapolis, IN
Moshannon Valley Parent Teacher
Organization, Houtzdale, PA
Nanston Educational Foundation, Inc.,
Norcross, GA
National Organization for Water
Awareness, Wallingford, CT
National Sports Concepts, Inc.,
Canton, OH
Naturelands Project, San Diego, CA
New Directions Treatment Center,
Danville, IL
New Images, Inc., Pine Bluff, AR
New Jersey Coalition for Inclusive
Education, Inc., Turnersville, NJ
New Vision Enterprises, Inc.,
South Pasadena, CA
N F A Crew Booster Club, Inc.,
Newburgh, NY
Noeticus, Plymouth, MN
North Bergen Urban Enterprise Zone
Development Corporation,
W. Caldwell, NJ
North Caldwell Hoops, Inc.,
North Caldwell, NJ
North Philadelphia Financial Partnership,
Philadelphia, PA
North Star Academy, Philadelphia, PA
Northeast Homeownership Consortium,
Inc., Oklahoma City, OK
Northern Kentucky School-to-Work
Partnership, Inc., Covington, KY
Nueva Esperanza-Camden, Inc.,
Camden, NJ

Old Bridge Youth Hockey Association, Inc., Hazlet, NJ
Omega Phi Alpha Scholarship Fund Trust, Fort Worth, TX
Our Lady of Fatima Society of Holy Cross of Harrison, Inc., Harrison, NJ
Our World of Learning, West Mifflin, PA
Parents and Community Together of Northeast Cincinnati, Maineville, OH
Parents Association, Westerville, OH
Park Forest Community Development Corporation, Park Forest, IL
Parkvision 98, Belleville, IL
Partnership FPR Families, Inc., Richmond, VA
Paseo Gratis Foundation, San Antonio, TX
Pass It On, Montclair, NJ
Penn-Harris-Madison Educational Foundation, Inc., Mishawaka, IN
Pennsylvania Coalition to Prevent Teen Pregnancy, Harrisburg, PA
Philadelphia Festival Ballet, Princeton, NJ
Pinelands Chronically Ill Childrens Fund, Inc., Little Egg Harbor, NJ
Pipsqueaks, Inc., Pittsburgh, PA
Pittsburg Sunrise Rotary Foundation, Inc., Pittsburg, KS
Plymouth Education Foundation, Detroit, MI
Polish American Bobsleigh Federation, Inc., Shavertown, PA
Positive People, Inc., Chicago, IL
Psychiatric Resource Center, Inc., Palm Beach, FL
Puerto Rican Education Policy and Law Center, Harrisburg, PA
Purple Onion Production, Inc., Wallingford, CT
R. Clay Simmons Foundation for Community and Economic Development, Starkville, MS
Rainbow Wellness Center, Inc., Absecon, NJ
Redwood Area Quilters Association, New Ulm, MN
Reform Jewish Day School of Greater Philadelphia, Newton, PA
River Falls Community Arts Base, Inc., River Falls, WI
Rochelle Park Education Association Philanthropic Fund, Inc., Rochelle Park, NJ
Ronald N. Terrill Memorial Fund, Inc., Morrisville, VT
Rotary Club of Pike County Foundation, Waverly, OH
Rotary Club of Severna Park Foundation, Inc., Severna Park, MD
Round Table Services, Philadelphia, PA
Ruby Porter Family Counseling Center, Forest Park, IL
Rural Community Housing Assistance, Smithville, TN
Rural Housing Assistance, Alamo, TN
Saginaw High School Neighborhood Association, Saginaw, MI
San Antonio Mayors Committee for Employment of People with Disabilities, San Antonio, TX
San Marcos High School Alumni & Associates, Inc., Escondido, CA
Senior Citizens Home Safety Project, New Brunswick, NJ
Show Me Shooters, Inc., St. Louis, MO
Silveyville Parents Association, Dixon, CA
Singers Companye, Akron, OH
Smith College Class of 1946, Stamford, CT
Sojourner Truth Center for Ethnic Diversity, Inc., Chicago, IL
Solutions VII, Inc., Washington, DC
South Jersey Museum of Art and Culture, Inc., Somerdale, NJ
South Suburban Community Council, Riverdale, IL
Springfield Volunteer Memorial Fund, Inc., Springfield, PA
St. Charles High School Hockey Club, Inc., St. Charles, MO
St. Francis Humane Society of Buffalo County, Inc., Mondovi, WI
St. Joseph County Minority Health Coalition, South Bend, IN
Staten Island Children's Campaign Charitable Tr, Staten Island, NY
Sudanese-American Community Development, Minneapolis, MN
Sunrise Residential, Inc., Tinley Park, IL
Susana Mi Amor Fund, Huntington, NY
Sussex County Knights Hockey Club, Inc., Newton, NJ
Swartmore Rotary Charitable Tr, Media, PA
Tehillah Ministries, Inc., Macon, GA
Ten Ten Foundation, Greenwich, CT
Tennessee Warbirds, Inc., Prescott, AZ
Texas Music International, Inc., Austin, TX
Three Rivers Academic Mentoring, Inc., Three Rivers, MI
Thursday Night Live, Pittsburgh, PA
Tops Rural Housing Programs, Newport, TN
Tot N Teen Foundation, Inc., Lake Forest, CA
Tru Development and Human Services, Inc., Jacksonville, FL
UMOJA Works, Washington, DC
Unified Human Services, Inc., Wall, NJ
Union County Schools Endowment Fund, Inc., New Albany, MS
United Congregation of Chester County, Coatesville, PA
Universal Improvement Association, Plainfield, NJ
Upper Bluff Society, Joliet, IL
U.S. Friends of Nightingale House, Inc., Great Neck, NY
Veddersburg, Inc., Amsterdam, NY
Verona Educational Foundation, Inc., Verona, NJ
Volunteer Institute for Creative Educational Science, Rockwood, TN
Washington Regional Network for Livable Communities, Washington, DC
Watch Hill Security Trust, Watch Hill, RI
Webster International Associates, Manchester, MO
West Amwell Township Education Foundation, Inc., Lambertville, NJ
West Deptford Field of Dreams, Inc., Thorofare, NJ
Wings for Wishes, Ltd., Greenfield, WI
Wings of Healing-Minnesota Incest Recovery Project, Minneapolis, MN
Wings of Mercy Mid-Michigan, Inc., Midland, MI
Wisconsin Foundation for School Music, Inc., Madison, WI
Woman Theatre, Inc., Philadelphia, PA
Women In Unity Foundation, Seattle, WA
Wonder World Enterprises, Blair, NE
Ypsilanti Band Association, Inc., Ypsilanti, MI

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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EMPLOYMENT TAX—Cont.

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INCOME TAX— Cont.

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SELF-EMPLOYMENT TAX

*U.S. Government Printing Office: 2002— 491-341/60027

Help Us to Picture Them Home

Angela Williams

Missing From: Tulsa, OK on 03/15/2000 3:00:00 PM

Female, Age Now: 17
Ht:5'5 Wt:145 lbs.
Brown eyes, Brown hair

National Center for Missing and Exploited Children

Call 1-800-THE-LOST

(1-800-843-5678)

Proud Partners With
Internal Revenue Service

www.missingkids.com

Help Us to Picture Them Home

Jamel Williams

Missing From: Toledo, OH on 5/25/1994

Male, Age Now: 11
Blue eyes, Blonde hair

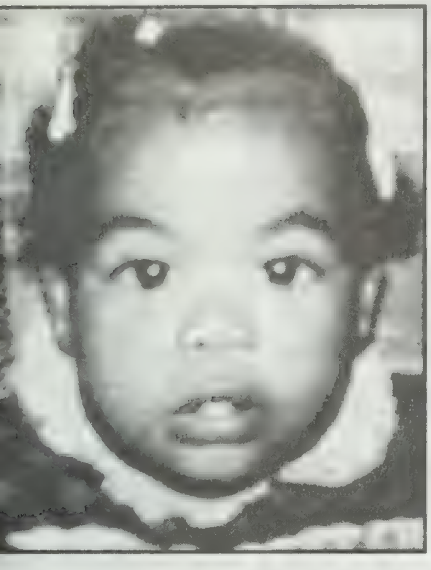
National Center for Missing and Exploited Children

Call 1-800-THE-LOST

(1-800-843-5678)

Proud Partners With
Internal Revenue Service

www.missingkids.com



Help Us to Picture Them Home

Olisa Williams

Missing From: Ann Arbor, MI on 02/08/1983

Female, Age Now: 20
Brown eyes, Brown hair

National Center for Missing and Exploited Children

Call 1-800-THE-LOST

(1-800-843-5678)

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Internal Revenue Service

NATIONAL CENTER FOR MISSING & EXPLOITED CHILDREN

www.missingkids.com

Help Us to Picture Them Home

Sara Wood

Missing From: Litchfield, NY on 08/18/1993

Female, Age Now: 20
Ht:5'0 Wt:96 lbs.
Blue eyes, Brown hair

National Center for Missing and Exploited Children

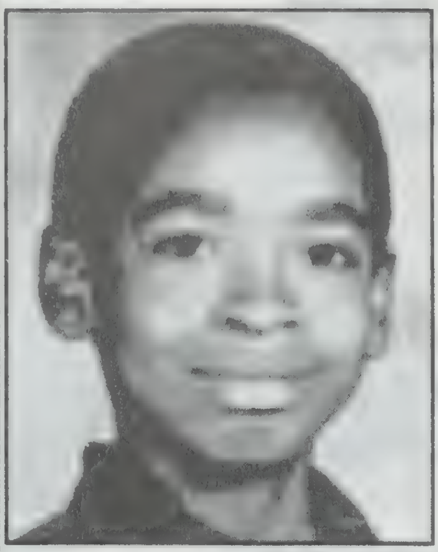
Call 1-800-THE-LOST

(1-800-843-5678)

Proud Partners With
Internal Revenue Service

NATIONAL CENTER FOR MISSING & EXPLOITED CHILDREN

www.missingkids.com



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Fred Wright

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bulletin

Bulletin No. 2002–19
May 13, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–22, page 849.
Gross income; transfers of property incident to divorce. A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse. Rev. Rul. 87–112 clarified.

Rev. Rul. 2002–24, page 848.
Low-income housing credit; satisfactory bond; "bond factor" amounts for the period April through June. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period April through June 2002.

Rev. Rul. 2002–25, page 904.
Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2002.

Rev. Rul. 2002–26, page 906.
Special use value; farms; interest rates. The 2002 interest rates to be used in computing the special use value of farm real property for which an election is made under section 2032A of the Code are listed for estates of decedents.

EMPLOYEE PLANS

T.D. 8987, page 852.
REG–108697–02, page 918.
Final, temporary, and proposed regulations under section 401 of the Code relate to required minimum distributions from qualified plans, section 457 plans, section 403(b) annuity plans, and retirement income accounts (IRAs).

Rev. Proc. 2002–21, page 911.
Professional employer organizations; employee leasing; plan qualification. This procedure describes different options that may be selected in order that certain defined contribution plans of professional employer organizations may avoid disqualification. Rev. Proc. 2002–6 modified.

Announcement 2002–49, page 919.
This announcement extends the June 1, 2002, date, cited in sections 4.01 and 4.05 of Rev. Proc. 2002–10 (2002–4 I.R.B. 401), to October 1, 2002, for which existing instead of revised model forms may be used to establish **new** IRAs, SEPs, and SIMPLE IRA plans.

EMPLOYMENT TAX

Notice 2002–31, page 908.
This document provides the contents of a proposed revenue ruling concerning the employment taxation and reporting of nonqualified stock options and nonqualified deferred compensation transferred to a former spouse incident to a divorce. The notice also requests comments from the public about the proposed ruling.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Rev. Proc. 2002–31, page 916.
For purposes of section 1.148–10(a)(4) of the regulations, this procedure sets forth a safe harbor under which an issue of tax or revenue anticipation bonds will not be treated as outstanding longer than is reasonably necessary to accomplish the governmental purposes of the bonds. This procedure applies to bonds sold after May 13, 2002.

Announcement 2002–52, page 919.
This announcement updates information concerning the filing of Form 8851, *Summary of Archer MSAs*. This information is general in nature and does not affect the current filing instructions for Form 8851 found in Rev. Proc. 2001–31 (2001–1 C.B. 1170).

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The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period April through June. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period of April through June 2002.

Rev. Rul. 2002–24

In Rev. Rul. 90–70 (1990–2 C.B. 3), the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of "bond factor" amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11 (1999–1 C.B. 275) established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of the low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period April through June 2002.

Table 1
Rev. Rul. 2002–24
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Apr '02	17.76	32.73	45.44	56.24	65.46	65.40	65.93	66.45	67.08	67.80	68.68
May '02	17.76	32.73	45.44	56.24	65.46	65.23	65.76	66.27	66.91	67.62	68.50
Jun '02	17.76	32.73	45.44	56.24	65.46	65.06	65.59	66.11	66.74	67.46	68.33

Table 1 (cont'd)
Rev. Rul. 2002–24
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

Month of Disposition	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year			
	1999	2000	2001	2002
Apr '02	69.55	70.40	71.67	72.55
May '02	69.38	70.24	71.51	72.55
Jun '02	69.21	70.09	71.37	72.55

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3 (1998–1 C.B. 248); Rev. Rul. 2001–2 (2001–1 C.B. 255); and Rev. Rul. 2001–53 (2001–46 I.R.B. 489). For dispositions occurring during the period January through March 2002, see Rev. Rul. 2002–8 (2002–9 I.R.B. 564).

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory N. Doran of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Doran at (202) 622–3040 (not a toll-free call).

Section 61.—Gross Income Defined

26 CFR 1.61–1: Gross income.
(Also: § 83, 1041; 1.83–7, 1.1041–1T.)

Gross income; transfers of property incident to divorce. A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

Rev. Rul. 2002–22

ISSUES

(1) Is a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce required to include an amount in gross income upon the transfer?

(2) Is the taxpayer or the former spouse required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse?

FACTS

Prior to their divorce in 2002, *A* and *B* were married individuals residing in State *X* who used the cash receipts and disbursements method of accounting.

A is employed by Corporation *Y*. Prior to the divorce, *Y* issued nonstatutory stock options to *A* as part of *A*'s compensation. The nonstatutory stock options did not have a readily ascertainable fair market value within the meaning of § 1.83–7(b) of the Income Tax Regulations at the time granted to *A*, and thus no amount was included in *A*'s gross income with respect to those options at the time of grant.

Y maintains two unfunded, nonqualified deferred compensation plans under which *A* earns the right to receive post-employment payments from *Y*. Under one of the deferred compensation plans, participants are entitled to payments based on the balance of individual accounts of the kind described in § 31.3121(v)(2)–1(c)(1)(ii) of the Employment Tax Regulations. By the time of *A*'s divorce from *B*, *A* had an account balance of $100*x* under that plan. Under the second deferred compensation plan maintained by *Y*, participants are entitled to receive single sum or periodic payments following separation from service based on a formula reflecting their years of service and compensation history with *Y*. By the time of *A*'s divorce from *B*, *A* had accrued the right to receive a single sum payment of $50*x* under that plan following *A*'s termination of employment with *Y*. *A*'s contractual rights to the deferred compensation benefits under these plans were not contingent on *A*'s performance of future services for *Y*.

Under the law of State *X*, stock options and unfunded deferred compensation rights earned by a spouse during the period of marriage are marital property subject to equitable division between the spouses in the event of divorce. Pursuant to the property settlement incorporated

into their judgment of divorce, *A* transferred to *B* (1) one-third of the nonstatutory stock options issued to *A* by *Y*, (2) the right to receive deferred compensation payments from *Y* under the account balance plan based on $75*x* of *A*'s account balance under that plan at the time of the divorce, and (3) the right to receive a single sum payment of $25*x* from *Y* under the other deferred compensation plan upon *A*'s termination of employment with *Y*.

In 2006, *B* exercises all of the stock options and receives *Y* stock with a fair market value in excess of the exercise price of the options. In 2011, *A* terminates employment with *Y*, and *B* receives a single sum payment of $150*x* from the account balance plan and a single sum payment of $25*x* from the other deferred compensation plan.

LAW AND ANALYSIS

Section 1041 and the assignment of income doctrine

Section 1041(a) provides that no gain or loss is recognized on a transfer of property from an individual to or for the benefit of a spouse or, if the transfer is incident to divorce, a former spouse. Section 1041(b) provides that the property transferred is generally treated as acquired by the transferee by gift and that the transferee's basis in the property is the adjusted basis of the transferor.

Section 1041 was enacted in part to reverse the effect of the Supreme Court's decision in *United States v. Davis*, 370 U.S. 65 (1962), which held that the transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims was a taxable event resulting in the recognition of gain or loss to the transferor. *See* H.R. Rep. No. 432, 98th Cong., 2d Sess. 1491 (1984). Section 1041 was intended to "make the tax laws as unintrusive as possible with respect to relations between spouses" and to provide "uniform Federal income tax consequences" for transfers of property between spouses incident to divorce, "notwithstanding that the property may be subject to differing state property laws." *Id.* at 1492. Congress thus intended that § 1041 would eliminate differing federal tax treatment of property transfers and divisions between divorcing taxpayers who reside in community property states and those who reside in noncommunity property states.

The term "property" is not defined in § 1041. However, there is no indication that Congress intended "property" to have a restricted meaning under § 1041. To the contrary, Congress indicated that § 1041 should apply broadly to transfers of many types of property, including those that involve a right to receive ordinary income that has accrued in an economic sense (such as interests in trusts and annuities). *Id.* at 1491. Accordingly, stock options and unfunded deferred compensation rights may constitute property within the meaning of § 1041. *See also Balding v. Commissioner*, 98 T.C. 368 (1992) (marital rights to military pension treated as property under § 1041).

Although § 1041 provides nonrecognition treatment to transfers between spouses and former spouses, whether income derived from the transferred property and paid to the transferee is taxed to the transferor or the transferee depends upon the applicability of the assignment of income doctrine. As first enunciated in *Lucas v. Earl*, 281 U.S. 111 (1930), the assignment of income doctrine provides that income is ordinarily taxed to the person who earns it, and that the incidence of income taxation may not be shifted by anticipatory assignments. However, the courts and the Service have long recognized that the assignment of income doctrine does not apply to every transfer of future income rights. *See, e.g., Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970); *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974), *cert. denied*, 419 U.S. 826 (1974); Rev. Rul. 80–198 (1980–2 C.B. 113). Moreover, in cases arising before the effective date of § 1041, a number of courts had concluded that transfers of income rights between divorcing spouses were not voluntary assignments within the scope of the assignment of income doctrine. *See Meisner v. United States*, 133 F.3d 654 (8th Cir. 1998); *Kenfield v. United States*, 783 F.2d 966 (10th Cir. 1986); *Schulze v. Commissioner*, T.C.M. 1983–263; *Cofield v. Koehler*, 207 F. Supp. 73 (D. Kan. 1962).

In *Hempt Bros., Inc. v. United States*, the court concluded that the assignment of income doctrine should not apply to the transfer of accounts receivable by a cash basis partnership to a controlled corporation in a transaction described in § 351(a), where there was a valid business purpose for the transfer of the accounts receivable together with the other assets and liabilities of the partnership to effect the incorporation of an ongoing business. The court reasoned that application of the assignment of income doctrine to tax the transferor in such circumstances would frustrate the Congressional intent reflected in the nonrecognition rule of § 351(a). Accordingly, the transferee, not the transferor, was taxed as it received payment of the receivables. In Rev. Rul. 80–198, the Service adopted the court's position in *Hempt Bros.*, but ruled that the assignment of income doctrine would nonetheless apply to transfers to controlled corporations where there was a tax avoidance purpose.

Similarly, applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as *Meisner* that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.

Specific provisions governing nonstatutory stock options

Section 83(a) provides, in general, that if property is transferred to any person in connection with the performance of services, the excess of the fair market value of the property over the amount, if any, paid for the property is included in the gross income of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. In the case of nonstatutory stock options that do not have a readily

ascertainable fair market value at the date of grant, § 83 does not apply to the grant of the option, but applies to property received upon exercise of the option or to any money or other property received in an arm's length disposition of the option. *See* § 83(e) and § 1.83–7(a).

Although a transfer of nonstatutory stock options in connection with a marital property settlement may, as a factual matter, involve an arm's length exchange for money, property, or other valuable consideration, it would contravene the gift treatment prescribed by § 1041 to include the value of the consideration in the transferor's income under § 83. Accordingly, the transfer of nonstatutory stock options between divorcing spouses is entitled to nonrecognition treatment under § 1041.

When the transferee exercises the stock options, the transferee rather than the transferor realizes gross income to the extent determined by § 83(a). Since § 1041 was intended to eliminate differing federal tax treatment for property transferred or divided between spouses in connection with divorce in community property states and in non-community property states, § 83(a) is properly applied in the same manner in both contexts. Where compensation rights are earned through the performance of services by one spouse in a community property state, the portion of the compensation treated as owned by the non-earning spouse under state law is treated as the gross income of the non-earning spouse for federal income tax purposes. *Poe v. Seaborn*, 282 U.S. 101 (1930). Thus, even though the non-employee spouse in a non-community property state may not have state law ownership rights in nonstatutory stock options at the time of grant, § 1041 requires that the ownership rights acquired by such a spouse in a marital property settlement be given the same federal income tax effect as the ownership rights of a non-employee spouse in a community property state. Accordingly, upon the subsequent exercise of the nonstatutory stock options, the property transferred to the non-employee spouse has the same character and is includible in the gross income of the non-employee spouse under § 83(a) to the same extent as if the non-employee spouse were the person who actually performed the services.

The same conclusion would apply in a case in which an employee transfers a statutory stock option (such as those governed by § 422 or 423(b)) contrary to its terms to a spouse or former spouse in connection with divorce. The option would be disqualified as a statutory stock option, see §§ 422(b)(5) and 423(b)(9), and treated in the same manner as other nonstatutory stock options. Section 424(c)(4), which provides that a § 1041(a) transfer of stock acquired on the exercise of a statutory stock option is not a disqualifying disposition, does not apply to a transfer of the stock option. *See* H.R. Rep. No. 795, 100th Cong., 2d Sess. 378 (1988) (noting that the purpose of the amendment made to § 424(c) is to "clarif[y] that the transfer of stock acquired pursuant to the exercise of an incentive stock option between spouses or incident to divorce is tax free").

CONCLUSION

Under the present facts, the interests in nonstatutory stock options and nonqualified deferred compensation that *A* transfers to *B* are property within the meaning of §1041. Section 1041 confers nonrecognition treatment on any gain that *A* might otherwise realize when *A* transfers these interests to *B* in 2002. Further, the assignment of income doctrine does not apply to these transfers. Therefore, *A* is not required to include in gross income any income resulting from *B*'s exercise of the stock options in 2006 or the payment of deferred compensation to *B* in 2011. When *B* exercises the stock options in 2006, *B* must include in income an amount determined under § 83(a) as if *B* were the person who performed the services. In addition, *B* must include the amount realized from payments of deferred compensation in income in the year such payments are paid or made available to *B*. The same conclusions would apply if *A* and *B* resided in a community property state and all or some of these income rights constituted community property that was divided between *A* and *B* as part of their divorce.

This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer. *See Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996). Transfers of certain types of property incident to divorce, the tax consequences of which are governed by a specific provision of the Code or regulations (for example, § 402, 408, 414, 424, or 453B) are not affected by this ruling.

HOLDINGS

(1) A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer.

(2) The former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

PROSPECTIVE APPLICATION

The Service will apply § 7805(b) and assignment of income principles to treat income as gross income of the transferor and not of the transferee if—

(i) The income is attributable to an interest in nonstatutory stock options, unfunded deferred compensation rights, or other similar intangible property rights;

(ii) The options or rights were transferred from one party to a divorce to the other party to the divorce;

(iii) The transfer was required by a provision of an agreement or court order;

(iv) The provision was contained in the agreement or order before November 9, 2002; and

(v) (a) The agreement or court order specifically provides that the transferor must report gross income attributable to the transferred interest, or

(b) It can be established to the satisfaction of the Service that the transferor

has reported the gross income for federal income tax purposes.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 87–112 (1987–2 C.B. 207) which deals with the treatment of transfers of United States savings bonds between spouses or former spouses, is clarified by eliminating references to assignment of income principles. As so clarified, the ruling is reaffirmed respecting the application of § 454 and the regulations thereunder to the transfer and the determination of the transferee's basis.

FURTHER INFORMATION

For further information or questions regarding § 61 or 1041, contact Edward Schwartz of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4960. For further information or questions regarding § 83, 402, 408, 414, 422, 423, 424, or 453B, contact Erinn Madden of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622–6030. These are not toll-free calls.

Section 83.—Property Transferred in Connection With Performance of Services

26 CFR 1.83–7: Taxation of nonqualified stock options.

A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse. See Rev. Rul. 2002–22, page 849.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

26 CFR 1.401(a)–2: Impossibility of diversion under qualified plan or trust.

A revenue procedure describes limited relief from disqualification for certain defined contribution retirement plans maintained by Professional Employer Organizations. See Rev. Proc. 2002–21, page 911.

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26 CFR 1.401(a)(9)–1: Minimum distribution requirement in general.

T.D. 8987

DEPARTMENT OF TREASURY
Internal Revenue Service
26 CFR Parts 1, 54, and 602

Required Distributions From Retirement Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to required minimum distributions from qualified plans, individual retirement plans, deferred compensation plans under section 457, and section 403(b) annuity contracts, custodial accounts, and retirement income accounts. These regulations will provide the public with guidance necessary to comply with the law and will affect administrators of, participants in, and beneficiaries of qualified plans; institutions that sponsor and individuals who administer individual retirement plans, individuals who use individual retirement plans for retirement income, and beneficiaries of individual retirement plans; and employees for whom amounts are contributed to section 403(b) annuity contracts, custodial accounts, or retirement income accounts and beneficiaries of such contracts and accounts. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of the **Federal Register**.

EFFECTIVE DATE: These regulations are effective January 1, 2003.

FOR FURTHER INFORMATION CONTACT: Cathy A. Vohs, 202–622–6090 (Not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the **Office of Management and Budget** in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–0996, in conjunction with the notice of proposed rulemaking published on July 27, 1987, 52 FR 28070, REG-EE-113-82 (1987–2 C.B. 881), Required Distributions From Qualified Plans and Individual Retirement Plans, under control number 1545–1466 for Third-Party Disclosure Requirements in IRS Regulations, and control number 1545–1573, in conjunction with the notice of proposed rulemaking published on December 30, 1997, 62 FR 67780, REG–209463–82 (1998–1 C.B. 376), Required Distributions from Qualified Plans and Individual Retirement Plans. Responses to the collections of information under control numbers 1545–0996 and 1545–1466 are mandatory. Responses to the collection of information under control number 1545–1573 are required to obtain the benefit of a trust being treated as a designated beneficiary under a retirement plan.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the **Office of Management and Budget**.

The estimated annual burden per respondent under control number 1545–0996 is 1 hour.

The estimated annual burden per respondent under control number 1545–1466 is 9 minutes.

The estimated annual burden per respondent under control number 1545–1573 is 20 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR: MP:FP:S Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) and to the Pension Excise Tax Regulations (26 CFR Part 54) under sections 401, 403, 408, and 4974 of the Internal Revenue Code of 1986 (Code). These amendments conform the regulations to section 634 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 117), section 1404 of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1791), sections 1121 and 1852 of the Tax Reform Act of 1986 (TRA of 1986) (100 Stat. 2464 and 2864), sections 521 and 713 of the Tax Reform Act of 1984 (TRA of 1984) (98 Stat. 865 and 955), and sections 242 and 243 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (96 Stat. 521). The regulations provide guidance on the minimum distribution requirements under section 401(a)(9) for plans qualified under section 401(a) and for other arrangements that incorporate the section 401(a)(9) rules by reference. The section 401(a)(9) rules are incorporated by reference in sections 408(a)(6) and (b)(3) for individual retirement accounts and annuities (IRAs) (including Roth IRAs, except as provided in section 408A(c)(5)), section 403(b)(10) for section 403(b) annuity contracts, and section 457(d) for eligible deferred compensation plans.

For purposes of this discussion of the background of the regulations in this preamble, as well as the explanation of provisions below, whenever the term *employee* is used, it is intended to include not only an employee but also an IRA owner.

Section 401(a)(9) provides rules for distributions during the life of the employee in section 401(a)(9)(A) and rules for distributions after the death of the employee in section 401(a)(9)(B). Section 401(a)(9)(A)(ii) provides that the entire interest of an employee in a qualified plan must be distributed, beginning not later than the employee's required beginning date, in accordance with regulations, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the employee and a designated beneficiary).

Section 401(a)(9)(C) defines required beginning date for employees (other than 5-percent owners and IRA owners) as April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. For 5-percent owners and IRA owners, the required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70½, even if the employee has not retired.

Section 401(a)(9)(D) provides that (except in the case of a life annuity) the life expectancy of an employee and the employee's spouse that is used to determine the period over which payments must be made may be redetermined, but not more frequently than annually.

Section 401(a)(9)(E) provides that the term *designated beneficiary* means any individual designated as a beneficiary by the employee.

Section 401(a)(9)(G) provides that any distribution required to satisfy the incidental death benefit requirement of section 401(a) is a required minimum distribution.

Section 401(a)(9)(B)(i) provides that, if the employee dies after distributions have begun, the employee's interest must be distributed at least as rapidly as under the method used by the employee.

Section 401(a)(9)(B)(ii) and (iii) provides that, if the employee dies before required minimum distributions have begun, the employee's interest must be either: distributed (in accordance with regulations) over the life or life expectancy of the designated beneficiary with the distributions beginning no later than 1 year after the date of the employee's death, or distributed within 5 years after the death of the employee. However, under section 401(a)(9)(B)(iv), a surviving spouse may wait until the date the employee would have attained age 70½ to begin taking required minimum distributions.

Comprehensive proposed regulations under section 401(a)(9) were previously published in the **Federal Register** on January 17, 2001 (REG–130477–00/ REG–130481–00, 2001–1 C.B. 865 [66 FR 3928]) and July 27, 1987 (EE–113–82, 1987–2 C.B. 881 [52 FR 28070]). The proposed regulations published in 2001 substantially simplified the rules for determining required minimum distributions for separate accounts provided in the 1987 proposed regulations. The public reaction to this simplification was very favorable. Consequently, these final regulations adopt the simplified rules in the 2001 proposed regulations for separate accounts, with the modifications described below in the Explanation of Provisions. These regulations continue to incorporate, with some modifications, applicable previously issued guidance (*i.e.*, Notice 83–23 (1983–2 C.B. 418), Notice 88–38 (1988–1 C.B. 524), Notice 96–67 (1996–2 C.B. 235), and Notice 97–75 (1997–2 C.B. 337)). To the extent not modified or superceded by these regulations, the guidance in Notice 83–23 and Notice 97–75 remains in effect. For example, if an employer uses the same required beginning date for all employees regardless of whether the employee has retired by age 70½, during the period before an employee retires, the employee may determine the portion of any distribution that is eligible for rollover using the statutory definition of required beginning date.

With respect to annuity payments, the 2001 proposed regulations retained the

basic structure of the 1987 proposed regulation. The preamble to the 2001 proposed regulations indicated that the IRS and Treasury were continuing to study these rules and specifically requested updated comments on current practices and issues relating to required minimum distributions from annuity contracts. Commentators provided information on the variety of annuity contracts being developed and available as insurance company products for purchase with separate accounts. In response to the comments received, temporary regulations under § 1.401(a)(9)–6T significantly expand the situations in which annuity payments under annuity contracts purchased with an employee's benefit may provide for increasing payments. These regulations are being issued in proposed (REG–108697–02) and temporary form rather than final form in order to give taxpayers an opportunity to comment on these changes.

Explanation of Provisions

Uniform Lifetime Table

These final regulations retain the simplifications to the minimum distribution rules for separate accounts provided in the 2001 proposed regulations, including the calculation of the required minimum distribution during the individual's lifetime using a uniform table. The basic calculation for individual accounts provides that the required minimum distribution is determined by dividing the account balance by the distribution period. For lifetime required minimum distributions, there is a uniform distribution period for almost all employees of the same age. The uniform lifetime distribution period table is based on the joint life and last survivor expectancy of an individual and a hypothetical beneficiary 10 years younger. However, if the employee's sole beneficiary is the employee's spouse and the spouse is more than 10 years younger than the employee, a longer distribution period measured by the joint life and last survivor life expectancy of the employee and spouse is permitted to be used.

For years after the year of the employee's death, the distribution period is generally the remaining life expectancy of the designated beneficiary. The beneficiary's remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the employee's death, reduced by one for each subsequent year. If the employee's spouse is the employee's sole beneficiary, the distribution period during the spouse's life is the spouse's single life expectancy. For years after the year of the spouse's death, the distribution period is the spouse's life expectancy calculated in the year of death, reduced by one for each subsequent year. If there is no designated beneficiary, the distribution period is the employee's life expectancy calculated in the year of death, reduced by one for each subsequent year.

New Mortality Tables

The 2001 proposed regulations provided that the life expectancies for purposes of section 401(a)(9) would be determined using the expected return multiples set forth in the regulations under section 72 that are used for other purposes under the Code. These tables, based upon the experience reflected in the 1983 individual annuity mortality table (without load), were adopted for purposes of section 72 in 1986 and had been used in both the 1987 proposed regulations and the 2001 proposed regulations under section 401(a)(9).

Section 634 of EGTRRA instructed the Secretary of Treasury to modify the life expectancy tables used for purposes of the minimum distribution rules to reflect current life expectancy. In accordance with that instruction, the final regulations adopt new tables of life expectancies to be used for determining required minimum distributions.

The new tables were derived by starting with the basic 2000 individual annuity mortality table and projecting mortality improvement for the period 2000 through 2003 using the assumed mortality improvement factors that were adopted in developing the Annuity 2000 mortality table. The resulting mortality rates were blended using a fixed 50% male 50% female blend. The uniform lifetime table provided in these final regulations has also been adjusted to reflect these new mortality tables.

These new tables also may be used to determine an employee's (or IRA owner's) life expectancy, or the joint life and last survivor expectancy of an employee (or IRA owner) and designated beneficiary, for purposes of calculating the amount of substantially equal periodic payments under section 72(t)(2)(A)(iv) when applying a method permitted under A–12 of Notice 89–25 (1989–1 C.B. 662, 666). One of these methods allows use of the methodology underlying the minimum distribution calculations for separate accounts in which the account balance in the prior year is divided by life expectancy or joint life and last survivor expectancy. Under this method, the payments are not equal but are treated as substantially equal if the life expectancy is determined in a consistent manner. A series of substantially equal periodic payments under section 72(t)(2)(A)(iv) determined under this methodology will not be considered to have been modified merely because the new tables are used in the future to determine the annual periodic payments rather than the tables in the regulations under section 72.

Determination of the Designated Beneficiary

The 2001 proposed regulations provided that, generally, the designated beneficiary is determined as of the end of the year following the year of the employee's death. Thus, any beneficiary eliminated by distribution of the beneficiary's benefit or through disclaimer during the period between the employee's death and the end of the year following the year of death is disregarded in determining the employee's designated beneficiary for purposes of calculating required minimum distributions. If, as of the end of the year following the year of the employee's death, the employee has more than one designated beneficiary and the account or benefit has not been divided into separate accounts or shares for each beneficiary, the beneficiary with the shortest life expectancy is the designated beneficiary. Further, if a person other than an individual is a beneficiary as of that date, the employee is treated as not having a beneficiary (except as provided below with respect to trusts).

Commentators applauded the basic principle of the approach in the 2001 proposed regulations but suggested that the designated beneficiary determination should be made before the end of the year following the year of death so that there

will be adequate time to calculate and distribute the required minimum amount between the date the beneficiary determination is finalized and the end of the year following the year of the employee's death (*i.e.*, the date that required minimum distributions to nonspouse designated beneficiaries must commence). In response to these comments, the date for determining the designated beneficiary has been changed to September 30 of the year following the year of the employee's death. In response to comments, these final regulations clarify that in order for a beneficiary to disclaim entitlement to a benefit for purposes of section 401(a)(9), the disclaimer must satisfy section 2518. Finally, the final regulations clarify that if a designated beneficiary dies during the period between the employee's date of death and September 30 of the year following the year of the employee's death, the individual continues to be treated as the designated beneficiary for purposes of determining the distribution period rather than the successor beneficiary.

Some commentators requested that final regulations provide that, if the employee's estate was named as the beneficiary in the beneficiary designation or the employee's estate became beneficiary by operation of law, the beneficiary of the estate or the beneficiary of the IRA named under the employee's will could replace the estate as beneficiary by September 30 of the year following the year of death. This change is not being adopted in these final regulations. The period between death and the beneficiary determination date is a period during which beneficiaries can be eliminated but not replaced with a beneficiary not designated under the plan as of the date of death. In order for an individual to be a designated beneficiary, any beneficiary must be designated under the plan or named by the employee as of the date of death.

These regulations retain the rule in the proposed regulations that, in determining an employee's beneficiaries for purposes of applying the multiple beneficiary rule or determining if the employee's spouse is the employee's sole beneficiary, all beneficiaries of the employee's interest in the plan, including contingent beneficiaries, are taken into account. The regulations also retain the exception to this rule under which, if a beneficiary (subsequent beneficiary) is entitled to any portion of an employee's benefit only if another beneficiary dies before the entire benefit to which that other beneficiary is entitled has been distributed by the plan, the subsequent beneficiary will not be considered a beneficiary. However, these regulations clarify that the exception from the multiple beneficiary rules for death contingencies only applies to a person who could be entitled to a portion of the employee's benefit by becoming the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. The regulations provide that this rule does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death. Thus, for example, if one beneficiary has a right to any income on an employee's individual account during that beneficiary's life and another beneficiary has a right to the principal but only after the death of the income beneficiary (with any portion of the principal distributed during the life of the income beneficiary to be held in trust until that beneficiary's death), both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.

Default Rule for Post-death Distributions

These regulations, as did the 2001 proposed regulations, provide that, if an employee dies before the employee's required beginning date and the employee has a designated beneficiary, then the life expectancy rule in section 401(a)(9)(B)(iii) (rather than the 5-year rule in section 401(a)(9)(B)(ii)) is the default distribution rule. Thus, absent a plan provision or election of the 5-year rule, the life expectancy rule applies in all cases in which the employee has a designated beneficiary, and the 5-year rule applies if the employee does not have a designated beneficiary. This is a change from the position in the 1987 proposed regulations that provided the 5-year rule as the default unless the spouse was the sole beneficiary. Commentators pointed out that, as a result of the default rule under the 1987 regulations, some beneficiaries did not commence distributions under the life expectancy rules. In response to those comments, these final regulations provide a transition rule that permits beneficiaries subject to the 5-year rule under the 1987 proposed regulations to switch to the life expectancy rule, provided that all amounts that would have been required to be distributed under an application of the life expectancy rule are distributed by the earlier of December 31, 2003 or the end of the 5-year period following the year of the employee's death.

Temporary Rules for Defined Benefit Plans and Annuity Contracts

These temporary regulations provide a number of changes to the annuity rules provided in the 2001 proposed regulations including changes designed to make the rules more consistent with the rules for individual accounts and reflect new product designs. In order to allow taxpayers to comment on these changes, the section of the regulations governing defined benefit plans and annuities is being issued as temporary and proposed regulations rather than final regulations.

In response to comments, the following changes are being made. First, annuity payments are permitted to be provided for a period certain that is as long as the period under the uniform lifetime table for the employee's age in the year in which the annuity starting date occurs, regardless of who is the employee's designated beneficiary. Further, the period does not change upon the death of the employee even if the remaining period certain is longer or shorter than the beneficiary's single life expectancy. The same rule applies if the annuity also includes a life annuity or a joint and survivor annuity. If the employee's sole designated beneficiary is the employee's spouse, if the spouse is more than 10 years younger than the employee, and if the annuity is only for a period certain and does not have a life contingent element, the period certain can be as long as the joint life and last survivor expectancy of the employee and the employee's spouse.

These temporary regulations retain the rules in the 2001 proposed regulations interpreting the minimum distribution incidental benefit requirement. Under

these rules, if the survivor of a joint and survivor annuity is not the employee's spouse and if the survivor annuitant is more than 10 years younger than the employee, then the survivor portion must be less than 100% of the employee's benefit. In such a case, the survivor annuity must be reduced so that it does not exceed the employee's benefit multiplied by the percentage provided in the table in the regulations. However, the regulations clarify that if the joint and survivor annuity also has a period certain, the reduction in survivor annuity is only required after expiration of the period certain.

Further, in response to comments, the temporary regulations make a number of changes that expand the situations in which increasing annuity payments are permitted. The additional situations are generally only available to annuities purchased from insurance companies.

Under these temporary regulations, an annuity purchased from an insurance company can increase annually by a constant percentage, provided that the initial payment is sufficiently large that the total expected payments, determined without regard to these increases, exceed the account value being annuitized. This minimum payment requirement, together with the adverse economic interests of the insurer and the annuity purchaser, effectively limits the constant percentage increase under an annuity to the assumed interest rate used in pricing the annuity.

These temporary regulations also provide explicit rules relating to the payments of dividends under participating annuity contracts. Under the temporary regulations, a variation in the amount of the annuity payment (referred to as a dividend or other payment resulting from favorable actuarial experience) can be made provided that: (1) the initial payment meets the minimum threshold described above, (2) actuarial experience is measured at least annually, and (3) the resulting dividend payment or other payment is either paid no later than the year following the year for which the actuarial experience is measured or is payable in the same form as the payment of the annuity over the remaining period of the annuity. These requirements are intended to preclude backloading of the distribution stream through the use of conservative pricing assumptions where actuarial gains with respect to those assumptions are deferred and paid at a later date. The definition of dividend or other payment resulting from actuarial gain is broad enough to encompass the contractual adjustment provided for in a variable annuity. Accordingly, the rules that permitted payments that vary with the investment performance of underlying assets have been replaced with this more general construct.

The temporary regulations allow full and partial withdrawals from purchased annuities in certain circumstances. The restrictions on these withdrawals are intended to preclude the use of a withdrawal or cash-out feature as a mechanism to distribute deferred actuarial gains. In the case of a full withdrawal (including a death benefit), the distribution must not exceed the expected future payments under the contract, taking into account the annuitants who are still alive and any remaining period certain, but without regard to any future increases. In the case of a partial withdrawal, the full withdrawal under the terms of the contract must satisfy the preceding sentence and, after the partial withdrawal, all future annuity payments must be reduced proportionately based on the ratio of the partial withdrawal to the maximum withdrawal under the terms of the contract.

As discussed above, these permitted increases are only available for insurance company products and not a distribution stream provided from a section 401(a) defined benefit trust. In addition, these temporary regulations do not permit annuity payments that vary with the value of the underlying assets of the plan to be provided by a defined benefit plan with a section 401(a) qualified trust. Further, these regulations clarify that an annuity under a defined benefit plan with a section 401(a) qualified trust is permitted to provide that annuity payments may increase with an annual percentage increase that does not exceed the percentage increase in a cost-of-living index that is based on prices of all items and issued by the Bureau of Labor Statistics. Finally, the temporary regulations clarify that increases in these annuity payments to reflect benefit increases must be pursuant to a plan amendment increasing benefits.

The preamble to the 2001 proposed regulations indicated that the IRS and Treasury were continuing to consider whether retention of the rule allowing an employee's minimum required distributions under a defined benefit plan to be determined using the rules for individual accounts was appropriate for defined benefit plans. Few comments specifically requested retention of this rule. As a result, the IRS and Treasury have concluded that this rule has little application outside of being used to determine the portion of a lump sum distribution of an employee's vested accrued benefit that is eligible for rollover. Accordingly, this rule has not been retained in these temporary regulations except for use in determining the amount that is eligible for rollover when a defined benefit plan pays an employee's entire vested accrued benefit in a lump sum. However, in response to comments, these temporary regulations permit a plan to treat the amount of a year of annuity payments that would have been payable under the normal form as the minimum required distribution for a year in the case of a lump sum payment.

Finally, in response to a comment, these temporary regulations clarify that actuarial increases to benefits under a defined benefit plan required under section 401(a)(9)(C)(iii), as added by SBJPA, need not be provided for any period before January 1, 1997.

Incidental Benefit Requirement

These final and temporary regulations provide rules relating to the interaction of the section 401(a)(9) requirements and the incidental benefit requirement of § 1.401–1(b)(1)(i). Under these rules, generally if distributions with respect to an employee's benefit satisfy the minimum distribution incidental benefit requirement under these regulations, the distribution will be deemed to satisfy any requirement for distributions under the incidental benefit requirements of § 1.401–1(b)(1)(i). However, if a plan provides for certain post-retirement ancillary death benefits or a section 403(b) contract includes an undistributed pre-1987 account, the employee's benefits must continue to satisfy the distribution requirements of the incidental benefit requirement of § 1.401–1(b)(1)(i), determined without regard to these regulations.

Existing revenue rulings continue to provide guidance with respect to the application of the incidental benefit requirements to permissible nonretirement benefits such as life, accident, or health benefits.

Trust as Beneficiary

The final regulations retain the provision in the proposed regulations allowing an underlying beneficiary of a trust to be an employee's designated beneficiary for purposes of determining required minimum distributions when the trust is named as the beneficiary of a retirement plan or IRA, provided that certain requirements are met. One of these requirements is that documentation of the underlying beneficiaries of the trust be provided to the plan administrator or IRA trustee, custodian, or issuer. In the case of individual accounts, unless the lifetime distribution period for an employee is measured by the joint life expectancy of the employee and the employee's spouse, the deadline under these regulations for providing the beneficiary documentation is October 31 of the year following the year of the employee's death, rather than the end of the year following the year of the employee's death as provided under the 2001 proposed regulations.

This deadline for providing the trust documentation is coordinated with the deadline for determining the employee's designated beneficiary. Amendments to the 1987 proposed regulations published in 1997 eliminated the requirement that the trust be irrevocable before death. Commentators indicated that some beneficiaries would have qualified for a longer distribution period as a result of this change except for the fact that they had not provided the required documentation by the deadline provided in the regulations, which, in some cases, was a date before the regulation was published. Consequently, the commentators requested that final regulations provide a transition period for providing this documentation. In response to these comments, these regulations provide that, if the date for providing this documentation is before October 31, 2003, the documentation is permitted to be provided to the plan administrator (or IRA trustee, custodian, or issuer) until October 31, 2003.

Commentators asked for clarification as to whether an election by a revocable trust to be treated as part of an estate under section 645 causes the trust to be treated as an estate for purposes of section 401(a)(9). On this point, the IRS and Treasury intend that a revocable trust will not fail to be a trust for purposes of section 401(a)(9) merely because the trust elects to be treated as an estate under section 645, as long as the trust continues to be a trust under state law.

Separate Accounts

Several commentators requested clarification concerning when an employee's individual account can be divided into separate accounts that are permitted to satisfy section 401(a)(9) separately and concerning whether separate accounts could also provide for separate investments. In response to these comments, these final regulations provide that separate accounts with different beneficiaries under the plan can be established at any time, either before or after the employee's required beginning date. However, the final regulations provide that the separate accounts are recognized for purposes of determining required minimum distributions only after the later of the year of the employee's death (whether before or after the required beginning date) and the year the separate accounts are established. In addition, the final regulations clarify that, in order to determine the distribution period for the separate account by disregarding the beneficiaries of the other separate account, the separate account must be established no later then the end of the year following the year of the employee's death.

The separate accounting must allocate all post-death investment gains and losses for the period prior to the establishment of the separate accounts on a *pro rata* basis in a reasonable and consistent basis among the separate accounts for the different beneficiaries. The separate accounting must also allocate any post-death distribution to the separate account of the beneficiary receiving that distribution. Once the separate accounts are established, the final regulations permit the separate accounting to provide for separate investments for each separate account.

Elimination of Optional Forms of Benefit

Some commentators requested relief under section 411(d)(6) for the elimination of optional forms of benefit that were needed to satisfy section 401(a)(9) under the 1987 proposed regulations but that are no longer needed to satisfy these final regulations. For defined contribution plans, this relief generally is not needed because paragraph (e) of A–2 of § 1.411(d)–4 gives broad authority to employers to amend their defined contribution plan to eliminate installment payout options as long as the right to a lump sum option payable at the same time is preserved. These final regulations also provide that, pursuant to section 411(d)(6)(B), a plan will not fail to satisfy section 411(d)(6) merely because the plan is amended to eliminate the availability of an optional form of benefit to the extent that the optional form does not satisfy section 401(a)(9). However, the IRS and Treasury invite public comment if additional relief under section 411(d)(6) is needed in order for defined benefit plans to satisfy section 401(a)(9).

Election of Surviving Spouse to Treat an Inherited IRA as Spouse's Own IRA

These final regulations generally retain the clarifications in the 2001 proposed regulations regarding how and when a surviving spouse of a deceased IRA owner can elect to treat an IRA inherited by the surviving spouse from that owner as the spouse's own IRA. The 1987 proposed regulations provided that this election is deemed to have been made if the surviving spouse contributes to the IRA or does not take the required minimum distribution for a year under section 401(a)(9)(B) as a beneficiary of the IRA. Under the 2001 proposed regulations, this deemed election is permitted to be made only after the distribution of the required minimum amount for the account, if any, for the year of the individual's death. These final regulations provide that the election can be made at any time after the IRA owner's date of death, while clarifying that the minimum required distribution for the calendar year of the IRA's owner's death is determined assuming the IRA owner lived throughout the year. These regulations also clarify that the surviving spouse is required to receive a

minimum distribution for the year of the IRA owner's death only to the extent that the amount required was not distributed to the owner before death.

Some commentators raised concerns about the other clarifications in the 2001 proposed regulations. The 2001 proposed regulations clarified that a deemed election is permitted only if the spouse is the sole beneficiary of the account and has an unlimited right to withdraw from the account. This requirement is not satisfied if a trust is named as beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust. As explained in the 2001 preamble, these clarifications make the election consistent with the underlying premise that the surviving spouse could have received a distribution of the entire decedent IRA owner's account and rolled it over to an IRA established in the surviving spouse's own name as IRA owner.

If the spouse actually receives a distribution from the IRA, the spouse is permitted to roll that distribution over within 60 days into an IRA in the spouse's own name to the extent that the distribution is not a required distribution, regardless of whether or not the spouse is the sole beneficiary of the IRA owner. Further, if the distribution is received by the spouse before the year that the IRA owner would have been 70½, no portion of the distribution is a required minimum distribution for purposes of determining whether it is eligible to be rolled over by the surviving spouse.

IRA Reporting of Required Minimum Distributions

The 2001 proposed regulations required the trustee, custodian, or issuer of an IRA to report the amount of the required minimum distribution from the IRA at the time and in the manner provided under additional guidance issued by the IRS and applicable IRS forms and instructions. A significant number of commentators objected to the requirement that the amount of the required minimum distribution for a year be reported because of concerns that the number may be inaccurate in certain cases. After thorough consideration of these comments and consultation with interested parties, the final regulations continue to provide authority to the Service to determine the extent to which the trustee, custodian, or issuer of an IRA must report information with respect to the required minimum distribution from that IRA through guidance of general applicability as well as forms and publications.

In conjunction with these final regulations a notice is being published that specifies the reporting requirements that apply. Beginning in 2004, trustees, custodians, and issuers must identify to the IRS on Form 5498 each IRA for which a minimum distribution is required to be made to an IRA owner. The trustee, custodian, or issuer does not need to report the amount of the required distribution to the IRS. However, the trustee, custodian, or issuer of such an IRA, must provide additional information regarding the IRA to the IRA owner required to receive a minimum required distribution, beginning with the minimum required distribution for 2003. The trustee, custodian, or issuer of the IRA either must report the amount of the required minimum distribution for the IRA to the IRA owner, or must advise the IRA owner that a minimum distribution with respect to the IRA is required for the year, offer to calculate the amount of the required minimum distribution for the IRA owner upon request, and then, if requested, calculate the amount and provide it to the IRA owner. Although the delegation of authority in the regulations to require reporting would permit reporting to be required with respect to required minimum distributions to beneficiaries, no reporting is required with respect to beneficiaries at this time.

The reporting provisions in the 2001 proposed regulations, these final regulations, and the notice being published are intended to assist taxpayers in complying with the minimum distribution requirement. However, the Treasury and the IRS continue to have concerns about the overall level of compliance in this area and intend to monitor the effect of the new reporting regime on compliance to determine whether it would be appropriate to modify the regime in the future.

Calculation Simplification

In response to comments that there are too many variables that might change during a distribution calendar year for an accurate calculation of the required minimum distribution for the year by the trustee at the beginning of the year, a number of simplifying changes are included in these final regulations. For lifetime distributions, the marital status of the employee is determined on January 1 each year. Divorce or death after that date is disregarded until the next year. Further, a change in beneficiary due to the spouse's death is not recognized until the following year. Contributions and distributions made after December 31 of a calendar year are disregarded for purposes of determining the minimum distribution for the following year. An employee's account balance for the valuation calendar year that is also the employee's first distribution calendar year is no longer reduced for a distribution on April 1 to satisfy the minimum distribution requirement for the first distribution calendar year. Contributions made after the calendar year that are allocated as of a date in the prior calendar year are no longer required to be added back. The only exceptions are rollover amounts, and recharacterized conversion contributions, that are not in any account on December 31 of a year. These changes are made to the qualified plan rules as well as IRA rules to maintain the parity between the rules.

Other Rules for IRAs

These final regulations retain the general rule that the rules applying section 401(a)(9) to qualified plans apply also to IRAs, unless otherwise provided. In addition to retaining the special rules for IRAs provided in the 2001 proposed regulations, these final regulations provide a special rule for trustee-to-trustee transfers between IRAs to coordinate with the rule that allows aggregation of IRA distributions. Although the IRA to IRA transfer is not treated as a distribution for purposes of section 401(a)(9), in light of the fact that the required minimum distribution with respect to the transferor IRA can be taken from any IRA, the transferor IRA will be able to transfer the entire balance and will not be required to retain the amount of the required minimum distribution for the year.

Section 403(b) Contracts

These regulations retain the basic rule in the 1987 and 2001 proposed regulations that a section 403(b) contract is treated as an individual retirement plan for purposes of satisfying the required minimum distribution rules. Consequently, the delegation of authority to require reporting with respect to IRAs also applies to section 403(b) contracts. However, the notice being issued in conjunction with these regulations provides that no reporting is required at this time with respect to required minimum distributions from section 403(b) contracts.

As requested in comments to the 1987 and the 2001 proposed regulations, these regulations provide that an annuity provided with respect to a section 403(b)(9) retirement income account will not fail to satisfy the requirements for annuity payment under an annuity contract merely because the annuity is not provided under a contract purchased from an insurance company.

Section 1852(a) of TRA '86 applied section 401(a)(9) to section 403(b) contracts effective for benefits accruing after December 31, 1986. The final regulations retain the rule in the proposed regulations interpreting the effective date of section 1852(a) of TRA '86 that does not apply section 401(a)(9) to the undistributed portion of the employee's account balance in a section 403(b) contract as of December 31, 1986 (the pre-'87 account balance). Further, the final regulations clarify that a contract will not lose the grandfather for a pre-'87 account balance merely because the account balance is transferred from one section 403(b) contract to another, provided the issuer of the transferee contract satisfies the recordkeeping requirements for the pre-'87 account balance. However, a distribution and rollover (including a direct rollover) of an amount from the pre-'87 account will cause that amount to lose the grandfather treatment.

Amendment of Qualified Plans

The IRS intends to publish procedures in the near future that will provide guidance on amending qualified plans to reflect these final regulations under section 401(a)(9).

Amendment of IRAs and Effective Date

Rev. Proc. 2002–10 (2002–4 I.R.B. 401), provides guidance on when IRA documents must be updated for these final regulations and for changes made by EGTRRA.

Effective Date

The regulations apply for determining required minimum distributions for calendar years beginning on or after January 1, 2003. For determining required minimum distributions for calendar year 2002, taxpayers may rely on these final regulations, the 2001 proposed regulations, or the 1987 proposed regulations.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations does not have a significant economic impact on a substantial number of small entities. This certification is based on the following. The only provisions requiring collection of information are in A–2 of § 1.401(a)(9)–1, A–4 of § 1.401(a)(9)–3, A–5 and A–6 of § 1.401(a)(9)–4, and A–2 of § 1.403(b)–3. The election described in A–4 of § 1.401(a)(9)–3 is expected to be an unusual occurrence for small entities because few individuals with benefits in retirement plans maintained by small entities are likely to make these elections. In the case of A–2 of § 1.401(a)(9)–1 and A–5 and A–6 of § 1.401(a)(9)–4, when determining required minimum distributions in cases where a plan participant wishes to designate a trust as beneficiary of the participant's benefit, the reporting burden is primarily on the plan participant, or trustee of the trust named as beneficiary, to supply information rather than on the entity maintaining the retirement plan and the fact that the number of participants per plan to whom the burden applies is insignificant. In A–2 of § 1.403(b)–3, the recordkeeping burden with respect to section 403(b) contracts under which the pre-1987 account balance must be maintained only applies to issuers and custodians of those contracts, which generally are not small entities. Therefore, a Regulatory Flexibility Analysis (5 U.S.C. chapter 6) is not required for this regulation. Pursuant to section 7805(f) of the Internal Revenue Code, the notices of proposed rulemaking preceding the final rule were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business and temporary § 1.401(a)(9)–6T will be submitted to the Chief Counsel for such comments.

Drafting Information

The principal authors of these regulations are Marjorie Hoffman and Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 1.401(a)(9)–1 is also issued under 26 U.S.C. 401(a)(9).

§ 1.401(a)(9)–2 is also issued under 26 U.S.C. 401(a)(9).

§ 1.401(a)(9)–3 is also issued under 26 U.S.C. 401(a)(9).

§ 1.401(a)(9)–4 is also issued under 26 U.S.C. 401(a)(9).

§ 1.401(a)(9)–5 is also issued under 26 U.S.C. 401(a)(9).

§ 1.401(a)(9)–6T is also issued under 26 U.S.C. 401(a)(9).

§ 1.401(a)(9)–7 is also issued under 26 U.S.C. 401(a)(9).

§ 1.401(a)(9)–8 is also issued under 26 U.S.C. 401(a)(9).

§ 1.401(a)(9)–9 is also issued under 26 U.S.C. 401(a)(9). * * *

§ 1.403(b)–3 is also issued under 26 U.S.C. 403(b)(10). * * *

§ 1.408–8 is also issued under 26 U.S.C. 408(a)(6) and (b)(3). * * *

Par. 2. Sections 1.401(a)(9)–0 through 1.401(a)(9)–9 are added to read as follows:

§ 1.401(a)(9)–0 Required minimum distributions; table of contents.

This table of contents lists the regulations relating to required minimum distributions under section 401(a)(9) of the Internal Revenue Code as follows:

§ 1.401(a)(9)–1 Minimum distribution requirement in general.

Q–1. What plans are subject to the minimum distribution requirement under section 401(a)(9), this section, and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9?

A–1. Under section 401(a)(9), all stock bonus, pension, and profit-sharing plans qualified under section 401(a) and annuity contracts described in section 403(a) are subject to required minimum distribution rules. See this section and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9 for the distribution rules applicable to these plans. Under section 403(b)(10), annuity contracts or custodial accounts described in section 403(b) are subject to required minimum distribution rules. See § 1.403(b)–3 for the distribution rules applicable to these annuity contracts or custodial accounts. Under sections 408(a)(6) and 408(b)(3), individual retirement plans (including, for some purposes, Roth IRAs under section 408A) are subject to required minimum distribution rules. See § 1.408–8 for the distribution rules applicable to individual retirement plans and see § 1.408A–6 for the distribution rules applicable to Roth IRAs under section 408A. Under section 457(d)(2), certain deferred compensation plans for employees of tax exempt organizations or state and local government employees are subject to required minimum distribution rules.

Q–2. Which employee account balances and benefits held under qualified trusts and plans are subject to the distribution rules of section 401(a)(9), this section, and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9?

A–2. (a) *In general.* The distribution rules of section 401(a)(9) apply to all account balances and benefits in existence on or after January 1, 1985. This section and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9 apply for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2003.

(b) *Beneficiaries.* (1) The distribution rules of this section and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9 apply to account balances and benefits held for the benefit of a beneficiary for calendar years beginning on or after January 1, 2003, even if the employee died prior to January 1, 2003. Thus, in the case of an employee who died prior to January 1, 2003, the designated beneficiary must be redetermined in accordance with the provisions of § 1.401(a)(9)–4 and the applicable distribution period (determined under § 1.401(a)(9)–5 or 1.401(a)(9)–6T, whichever is applicable) must be reconstructed for purposes of determining the amount required to be distributed for calendar years beginning on or after January 1, 2003.

(2) A designated beneficiary that is receiving payments under the 5-year rule of section 401(a)(9)(B)(ii), either by affirmative election or default provisions, may, if the plan so provides, switch to using the life expectancy rule of section 401(a)(9)(B)(iii) provided any amounts that would have been required to be distributed under the life expectancy rule of section 401(a)(9)(B)(iii) for all distribution calendar years before 2004 are distributed by the earlier of December 31, 2003, or the end of the 5-year period determined under A–2 of § 1.401(a)(9)–3.

(c) *Trust documentation.* If a trust fails to meet the rule of A–5 of § 1.401(a)(9)–4 (permitting the beneficiaries of the trust, and not the trust itself, to be treated as the employee's designated beneficiaries) solely because the trust documentation was not provided to the plan administrator by October 31 of the calendar year following the calendar year in which the employee died, and such documentation is provided to the plan administrator by October 31, 2003, the beneficiaries of the trust will be treated as designated beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).

Q–3. What specific provisions must a plan contain in order to satisfy section 401(a)(9)?

A–3. (a) *Required provisions.* In order to satisfy section 401(a)(9), the plan must include the provisions described in this paragraph reflecting section 401(a)(9). First, the plan must generally set forth the statutory rules of section 401(a)(9), including the incidental death benefit requirement in section 401(a)(9)(G). Second, the plan must provide that distributions will be made in accordance with this section and §§ 1.401(a)(9)–2 through 1.401(a)(9)–9. The plan document must also provide that the provisions reflecting section 401(a)(9) override any distribution options in the plan inconsistent with section 401(a)(9). The plan also must include any other provisions reflecting section 401(a)(9) that are prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(b) of this chapter.

(b) *Optional provisions.* The plan may also include written provisions regarding any optional provisions governing plan distributions that do not conflict with section 401(a)(9) and the regulations thereunder.

(c) *Absence of optional provisions.* Plan distributions commencing after an employee's death will be required to be made under the default provision set forth in § 1.401(a)(9)–3 for distributions unless the plan document contains optional provisions that override such default provisions. Thus, if distributions have not commenced to the employee at

the time of the employee's death, distributions after the death of an employee are to be made automatically in accordance with the default provisions in A–4(a) of § 1.401(a)(9)–3 unless the plan either specifies in accordance with A–4(b) of § 1.401(a)(9)–3 the method under which distributions will be made or provides for elections by the employee (or beneficiary) in accordance with A–4(c) of § 1.401(a)(9)–3 and such elections are made by the employee or beneficiary.

§ 1.401(a)(9)–2 Distributions commencing during an employee's lifetime.

Q–1. In the case of distributions commencing during an employee's lifetime, how must the employee's entire interest be distributed in order to satisfy section 401(a)(9)(A)?

A–1. (a) In order to satisfy section 401(a)(9)(A), the entire interest of each employee must be distributed to such employee not later than the required beginning date, or must be distributed, beginning not later than the required beginning date, over the life of the employee or joint lives of the employee and a designated beneficiary or over a period not extending beyond the life expectancy of the employee or the joint life and last survivor expectancy of the employee and the designated beneficiary.

(b) Section 401(a)(9)(G) provides that lifetime distributions must satisfy the incidental death benefit requirements.

(c) The amount required to be distributed for each calendar year in order to satisfy section 401(a)(9)(A) and (G) generally depends on whether a distribution is in the form of distributions under a defined contribution plan or annuity payments under a defined benefit plan or under an annuity contract. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(A) and (G) from an individual account under a defined contribution plan, see § 1.401(a)(9)–5. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(A) and (G) in the case of annuity payments from a defined benefit plan or an annuity contract, see § 1.401(a)(9)–6T.

Q–2. For purposes of section 401(a)(9)(C), what does the term *required beginning date* mean?

A–2. (a) Except as provided in paragraph (b) of this A–2 with respect to a 5-percent owner, as defined in paragraph (c) of this A-2, the term *required beginning date* means April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan.

(b) In the case of an employee who is a 5-percent owner, the term *required beginning date* means April 1 of the calendar year following the calendar year in which the employee attains age 70½.

(c) For purposes of section 401(a)(9), a 5-percent owner is an employee who is a 5-percent owner (as defined in section 416) with respect to the plan year ending in the calendar year in which the employee attains age 70½.

(d) Paragraph (b) of this A–2 does not apply in the case of a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term *church plan* means a plan maintained by a church for church employees, and the term *church* means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

(e) A plan is permitted to provide that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which an employee attains age 70½ regardless of whether the employee is a 5-percent owner.

Q–3. When does an employee attain age 70½?

A–3. An employee attains age 70½ as of the date six calendar months after the 70th anniversary of the employee's birth. For example, if an employee's date of birth was June 30, 1933, the 70th anniversary of such employee's birth is June 30, 2003. Such employee attains age 70½ on December 30, 2003. Consequently, if the employee is a 5-percent owner or retired, such employee's required beginning date is April 1, 2004. However, if the employee's date of birth was July 1, 1933, the 70th anniversary of such employee's birth would be July 1, 2003. Such employee would then attain age 70½ on January 1, 2004, and such employee's required beginning date would be April 1, 2005.

Q–4. Must distributions made before the employee's required beginning date satisfy section 401(a)(9)?

A–4. Lifetime distributions made before the employee's required beginning date for calendar years before the employee's first distribution calendar year, as defined in A–1(b) of § 1.401(a)(9)–5, need not be made in accordance with section 401(a)(9). However, if distributions commence before the employee's required beginning date under a particular distribution option, such as in the form of an annuity, the distribution option fails to satisfy section 401(a)(9) at the time distributions commence if, under terms of the particular distribution option, distributions to be made for the employee's first distribution calendar year or any subsequent distribution calendar year will fail to satisfy section 401(a)(9).

Q–5. If distributions have begun to an employee during the employee's lifetime (in accordance with section 401(a)(9)(A)(ii)), how must distributions be made after an employee's death?

A–5. Section 401(a)(9)(B)(i) provides that if the distribution of the employee's interest has begun in accordance with section 401(a)(9)(A)(ii) and the employee dies before his entire interest has been distributed to him, the remaining portion of such interest must be distributed at least as rapidly as under the distribution method being used under section 401(a)(9)(A)(ii) as of the date of his death. The amount required to be distributed for each distribution calendar year following the calendar year of death generally depends on whether a distribution is in the form of distributions from an individual account under a defined contribution plan or annuity payments under a defined benefit plan. For the method of determining the required minimum distribution in accordance with section 401(a)(9)(B)(i) from an individual account, see § 1.401(a)(9)–5. In the case of annuity payments from a defined benefit plan or an annuity contract, see § 1.401(a)(9)–6T.

Q–6. For purposes of section 401(a)(9)(B), when are distributions considered to have begun to the employee in accordance with section 401(a)(9)(A)(ii)?

A–6. (a) *General rule*. Except as otherwise provided in A–10 of § 1.401(a)(9)–6T, distributions are not treated as

having begun to the employee in accordance with section 401(a)(9)(A)(ii) until the employee's required beginning date, without regard to whether payments have been made before that date. Thus, section 401(a)(9)(B)(i) only applies if an employee dies on or after the employee's required beginning date. For example, if employee A retires in 2003, the calendar year A attains age 65½, and begins receiving installment distributions from a profit-sharing plan over a period not exceeding the joint life and last survivor expectancy of A and A's spouse, benefits are not treated as having begun in accordance with section 401(a)(9)(A)(ii) until April 1, 2009 (the April 1 following the calendar year in which A attains age 70½). Consequently, if A dies before April 1, 2009 (A's required beginning date), distributions after A's death must be made in accordance with section 401(a)(9)(B)(ii) or (iii) and (iv) and § 1.401(a)(9)–3, and not section 401(a)(9)(B)(i). This is the case without regard to whether the plan has distributed the minimum distribution for the first distribution calendar year (as defined in A–1(b) of § 1.401(a)(9)–5) before A's death.

(b) If a plan provides, in accordance with A–2(e) of this section, that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which an employee attains age 70½, an employee who dies on or after the required beginning date determined under the plan terms is treated as dying after the employee's distributions have begun for purposes of this A–6 even though the employee dies before the April 1 following the calendar year in which the employee retires.

§ 1.401(a)(9)–3 Death before required beginning date.

Q–1. If an employee dies before the employee's required beginning date, how must the employee's entire interest be distributed in order to satisfy section 401(a)(9)?

A–1. (a) Except as otherwise provided in A–10 of § 1.401(a)(9)–6T, if an employee dies before the employee's required beginning date (and, thus, before distributions are treated as having begun in accordance with section 401(a)(9)(A)(ii)), distribution of the employee's entire interest must be made in accordance with one of the methods described in section 401(a)(9)(B)(ii) or (iii) and (iv). One method (the 5-year rule in section 401(a)(9)(B)(ii)) requires that the entire interest of the employee be distributed within 5 years of the employee's death regardless of who or what entity receives the distribution. Another method (the life expectancy rule in section 401(a)(9)(B)(iii) and (iv)) requires that any portion of an employee's interest payable to (or for the benefit of) a designated beneficiary be distributed, commencing within one year of the employee's death, over the life of such beneficiary (or over a period not extending beyond the life expectancy of such beneficiary). Section 401(a)(9)(B)(iv) provides special rules where the designated beneficiary is the surviving spouse of the employee, including a special commencement date for distributions under section 401(a)(9)(B)(iii) to the surviving spouse.

(b) See A–4 of this section for the rules for determining which of the methods described in paragraph (a) of this A–1 applies. See A–3 of this section to determine when distributions under the exception to the 5-year rule in section 401(a)(9)(B)(iii) and (iv) must commence. See A–2 of this section to determine when the 5-year period in section 401(a)(9)(B)(ii) ends. For distributions using the life expectancy rule in section 401(a)(9)(B)(iii) and (iv), see § 1.401(a)(9)–4 in order to determine the designated beneficiary under section 401(a)(9)(B)(iii) and (iv), see § 1.401(a)(9)–5 for the rules for determining the required minimum distribution under a defined contribution plan, and see § 1.401(a)(9)–6T for required minimum distributions under defined benefit plans.

Q–2. By when must the employee's entire interest be distributed in order to satisfy the 5-year rule in section 401(a)(9)(B)(ii)?

A–2. In order to satisfy the 5-year rule in section 401(a)(9)(B)(ii), the employee's entire interest must be distributed by the end of the calendar year which contains the fifth anniversary of the date of the employee's death. For example, if an employee dies on January 1, 2003, the entire interest must be distributed by the end of 2008, in order to satisfy the 5-year rule in section 401(a)(9)(B)(ii).

Q–3. When are distributions required to commence in order to satisfy the life expectancy rule in section 401(a)(9)(B)(iii) and (iv)?

A–3. (a) *Nonspouse beneficiary.* In order to satisfy the life expectancy rule in section 401(a)(9)(B)(iii), if the designated beneficiary is not the employee's surviving spouse, distributions must commence on or before the end of the calendar year immediately following the calendar year in which the employee died. This rule also applies to the distribution of the entire remaining benefit if another individual is a designated beneficiary in addition to the employee's surviving spouse. See A–2 and A–3 of § 1.401(a)(9)–8, however, if the employee's benefit is divided into separate accounts.

(b) *Spousal beneficiary.* In order to satisfy the rule in section 401(a)(9)(B)(iii) and (iv), if the sole designated beneficiary is the employee's surviving spouse, distributions must commence on or before the later of—

(1) The end of the calendar year immediately following the calendar year in which the employee died; and

(2) The end of the calendar year in which the employee would have attained age 70½.

Q–4. How is it determined whether the 5-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) applies to a distribution?

A–4. (a) *No plan provision.* If a plan does not adopt an optional provision described in paragraph (b) or (c) of this A–4 specifying the method of distribution after the death of an employee, distribution must be made as follows:

(1) If the employee has a designated beneficiary, as determined under § 1.401(a)(9)–4, distributions are to be made in accordance with the life expectancy rule in section 401(a)(9)(B)(iii) and (iv).

(2) If the employee has no designated beneficiary, distributions are to be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii).

(b) *Optional plan provisions.* A plan may adopt a provision specifying either that the 5-year rule in section 401(a)(9)(B)(ii) will apply to certain distributions after the death of an employee

even if the employee has a designated beneficiary or that distribution in every case will be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii). Further, a plan need not have the same method of distribution for the benefits of all employees in order to satisfy section 401(a)(9).

(c) *Elections*. A plan may adopt a provision that permits employees (or beneficiaries) to elect on an individual basis whether the 5–year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) applies to distributions after the death of an employee who has a designated beneficiary. Such an election must be made no later than the earlier of the end of the calendar year in which distribution would be required to commence in order to satisfy the requirements for the life expectancy rule in section 401(a)(9)(B)(iii) and (iv) (see A–3 of this section for the determination of such calendar year) or the end of the calendar year which contains the fifth anniversary of the date of death of the employee. As of the last date the election may be made, the election must be irrevocable with respect to the beneficiary (and all subsequent beneficiaries) and must apply to all subsequent calendar years. If a plan provides for the election, the plan may also specify the method of distribution that applies if neither the employee nor the beneficiary makes the election. If neither the employee nor the beneficiary elects a method and the plan does not specify which method applies, distribution must be made in accordance with paragraph (a) of this A–4.

Q–5. If the employee's surviving spouse is the employee's sole designated beneficiary and such spouse dies after the employee, but before distributions have begun to the surviving spouse under section 401(a)(9)(B)(iii) and (iv), how is the employee's interest to be distributed?

A–5. Pursuant to section 401(a)(9)(B)(iv)(II), if the surviving spouse is the employee's sole designated beneficiary and dies after the employee, but before distributions to such spouse have begun under section 401(a)(9)(B)(iii) and (iv), the 5–year rule in section 401(a)(9)(B)(ii) and the life expectancy rule in section 401(a)(9)(B)(iii) are to be applied as if the surviving spouse were the employee. In applying this rule, the date of death of the surviving spouse shall be substituted for the date of death of the employee. However, in such case, the rules in section 401(a)(9)(B)(iv) are not available to the surviving spouse of the deceased employee's surviving spouse.

Q–6. For purposes of section 401(a)(9)(B)(iv)(II), when are distributions considered to have begun to the surviving spouse?

A–6. Distributions are considered to have begun to the surviving spouse of an employee, for purposes of section 401(a)(9)(B)(iv)(II), on the date, determined in accordance with A–3 of this section, on which distributions are required to commence to the surviving spouse, even though payments have actually been made before that date. See A–11 of § 1.401(a)(9)–6T for a special rule for annuities.

§ 1.401(a)(9)–4 Determination of the designated beneficiary.

Q–1. Who is a designated beneficiary under section 401(a)(9)(E)?

A–1. A designated beneficiary is an individual who is designated as a beneficiary under the plan. An individual may be designated as a beneficiary under the plan either by the terms of the plan or, if the plan so provides, by an affirmative election by the employee (or the employee's surviving spouse) specifying the beneficiary. A beneficiary designated as such under the plan is an individual who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event. For example, if a distribution is in the form of a joint and survivor annuity over the life of the employee and another individual, the plan does not satisfy section 401(a)(9) unless such other individual is a designated beneficiary under the plan. A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, to identify the class member with the shortest life expectancy. The fact that an employee's interest under the plan passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan. See A–6 of § 1.401(a)(9)–8 for rules which apply to qualified domestic relation orders.

Q–2. Must an employee (or the employee's spouse) make an affirmative election specifying a beneficiary for a person to be a designated beneficiary under section 40l(a)(9)(E)?

A–2. No, a designated beneficiary is an individual who is designated as a beneficiary under the plan whether or not the designation under the plan was made by the employee. The choice of beneficiary is subject to the requirements of sections 401(a)(11), 414(p), and 417.

Q–3. May a person other than an individual be considered to be a designated beneficiary for purposes of section 401(a)(9)?

A–3. No, only individuals may be designated beneficiaries for purposes of section 401(a)(9). A person that is not an individual, such as the employee's estate, may not be a designated beneficiary. If a person other than an individual is designated as a beneficiary of an employee's benefit, the employee will be treated as having no designated beneficiary for purposes of section 401(a)(9), even if there are also individuals designated as beneficiaries. However, see A–5 of this section for special rules that apply to trusts and A–2 and A–3 of § 1.401(a)(9)–8 for rules that apply to separate accounts.

Q–4. When is the designated beneficiary determined?

A–4. (a) *General rule*. In order to be a designated beneficiary, an individual must be a beneficiary as of the date of death. Except as provided in paragraph (b) and § 1.401(a)(9)–6T, the employee's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death. Consequently, except as provided in § 1.401(a)(9)–6T, any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that September 30 (*e.g.*, because the person receives the entire benefit to which the person is entitled before that September 30), is not taken

into account in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death. Accordingly, if a person disclaims entitlement to the employee's benefit, pursuant to a disclaimer that satisfies section 2518 by that September 30 thereby allowing other beneficiaries to receive the benefit in lieu of that person, the disclaiming person is not taken into account in determining the employee's designated beneficiary.

(b) *Surviving spouse*. As provided in A–5 of § 1.401(a)(9)–3, if the employee's spouse is the sole designated beneficiary as of September 30 of the calendar year following the calendar year of the employee's death, and the surviving spouse dies after the employee and before the date on which distributions have begun to the surviving spouse under section 401(a)(9)(B)(iii) and (iv), the rule in section 40l(a)(9)(B)(iv)(II) will apply. Thus, for example, the relevant designated beneficiary for determining the distribution period after the death of the surviving spouse is the designated beneficiary of the surviving spouse. Similarly, such designated beneficiary will be determined based on the beneficiaries designated as of the date of the surviving spouse's death and who remain beneficiaries as of September 30 of the calendar year following the calendar year of the surviving spouse's death. Further, if, as of that September 30, there is no designated beneficiary under the plan with respect to that surviving spouse, distribution must be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii) and A–2 of § 1.401(a)(9)–3.

(c) *Deceased beneficiary*. For purposes of this A–4, an individual who is a beneficiary as of the date of the employee's death and dies prior to September 30 of the calendar year following the calendar year of the employee's death without disclaiming continues to be treated as a beneficiary as of the September 30 of the calendar year following the calendar year of the employee's death in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death, without regard to the identity of the successor beneficiary who is entitled to distributions as the beneficiary of the deceased beneficiary. The same rule applies in the case of distributions to which A–5 of § 1.401(a)(9)–3 applies so that, if an individual is designated as a beneficiary of an employee's surviving spouse as of the spouse's date of death and dies prior to September 30 of the year following the year of the surviving spouse's death, that individual will continue to be treated as a designated beneficiary.

Q–5. If a trust is named as a beneficiary of an employee, will the beneficiaries of the trust with respect to the trust's interest in the employee's benefit be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9)?

A–5. (a) If the requirements of paragraph (b) of this A–5 are met with respect to a trust that is named as the beneficiary of an employee under the plan, the beneficiaries of the trust (and not the trust itself) will be treated as having been designated as beneficiaries of the employee under the plan for purposes of determining the distribution period under section 401(a)(9).

(b) The requirements of this paragraph (b) are met if, during any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee, the following requirements are met —

(1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.

(2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.

(3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable within the meaning of A–1 of this section from the trust instrument.

(4) The documentation described in A–6 of this section has been provided to the plan administrator.

(c) In the case of payments to a trust having more than one beneficiary, see A–7 of § 1.401(a)(9)–5 for the rules for determining the designated beneficiary whose life expectancy will be used to determine the distribution period and A–3 of this section for the rules that apply if a person other than an individual is designated as a beneficiary of an employee's benefit. However, the separate account rules under A–2 of § 1.401(a)(9)–8 are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit.

(d) If the beneficiary of the trust named as beneficiary of the employee's interest is another trust, the beneficiaries of the other trust will be treated as being designated as beneficiaries of the first trust, and thus, having been designated by the employee under the plan for purposes of determining the distribution period under section 401(a)(9)(A)(ii), provided that the requirements of paragraph (b) of this A–5 are satisfied with respect to such other trust in addition to the trust named as beneficiary.

Q–6. If a trust is named as a beneficiary of an employee, what documentation must be provided to the plan administrator?

A–6. (a) *Required minimum distributions before death*. If an employee designates a trust as the beneficiary of his or her entire benefit and the employee's spouse is the sole beneficiary of the trust, in order to satisfy the documentation requirements of this A–6 so that the spouse can be treated as the sole designated beneficiary of the employee's benefits (if the other requirements of paragraph (b) of A–5 of this section are satisfied), the employee must either —

(1) Provide to the plan administrator a copy of the trust instrument and agree that if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of each such amendment; or

(2) Provide to the plan administrator a list of all of the beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement sufficient to establish that the spouse is the sole beneficiary) for purposes of section 401(a)(9); certify that, to the best of the employee's knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of A–5 of this section are satisfied; agree that, if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan

administrator corrected certifications to the extent that the amendment changes any information previously certified; and agree to provide a copy of the trust instrument to the plan administrator upon demand.

(b) *Required minimum distributions after death.* In order to satisfy the documentation requirement of this A–6 for required minimum distributions after the death of the employee (or spouse in a case to which A–5 of § 1.401(a)(9)–3 applies), by October 31 of the calendar year immediately following the calendar year in which the employee died, the trustee of the trust must either —

(1) Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement) as of September 30 of the calendar year following the calendar year of the employee's death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of paragraphs (b)(1), (2), and (3) of A–5 of this section are satisfied; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

(2) Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.

(c) *Relief for discrepancy between trust instrument and employee certifications or earlier trust instruments.* (1) If required minimum distributions are determined based on the information provided to the plan administrator in certifications or trust instruments described in paragraph (a) or (b) of this A–6, a plan will not fail to satisfy section 401(a)(9) merely because the actual terms of the trust instrument are inconsistent with the information in those certifications or trust instruments previously provided to the plan administrator, but only if the plan administrator reasonably relied on the information provided and the required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument.

(2) For purposes of determining the amount of the excise tax under section 4974, the required minimum distribution is determined for any year based on the actual terms of the trust in effect during the year.

§ 1.401(a)(9)–5 Required minimum distributions from defined contribution plans.

Q–1. If an employee's benefit is in the form of an individual account under a defined contribution plan, what is the amount required to be distributed for each calendar year?

A–1. (a) *General rule.* If an employee's accrued benefit is in the form of an individual account under a defined contribution plan, the minimum amount required to be distributed for each distribution calendar year, as defined in paragraph (b) of this A–1, is equal to the quotient obtained by dividing the account (determined under A–3 of this section) by the applicable distribution period (determined under A–4 or A–5 of this section, whichever is applicable). However, the required minimum distribution amount will never exceed the entire account balance on the date of the distribution. See A–8 of this section for rules that apply if a portion of the employee's account is not vested. Further, the minimum distribution required to be distributed on or before an employee's required beginning date is always determined under section 401(a)(9)(A)(ii) and this A–1 and not section 401(a)(9)(A)(i).

(b) *Distribution calendar year.* A calendar year for which a minimum distribution is required is a distribution calendar year. If an employee's required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70½, the employee's first distribution calendar year is the year the employee attains age 70½. If an employee's required beginning date is April 1 of the calendar year following the calendar year in which the employee retires, the employee's first distribution calendar year is the calendar year in which the employee retires. In the case of distributions to be made in accordance with the life expectancy rule in § 1.401 (a)(9)–3 and in section 401(a)(9)(B)(iii) and (iv), the first distribution calendar year is the calendar year containing the date described in A–3(a) or A–3(b) of § 1.401(a)(9)–3, whichever is applicable.

(c) *Time for distributions.* The distribution required to be made on or before the employee's required beginning date shall be treated as the distribution required for the employee's first distribution calendar year (as defined in paragraph (b) of this A–1). The required minimum distribution for other distribution calendar years, including the required minimum distribution for the distribution calendar year in which the employee's required beginning date occurs, must be made on or before the end of that distribution calendar year.

(d) *Minimum distribution incidental benefit requirement.* If distributions of an employee's account balance under a defined contribution plan are made in accordance with this section, the minimum distribution incidental benefit requirement of section 401(a)(9)(G) is satisfied. Further, with respect to the retirement benefits provided by that account balance, to the extent the incidental benefit requirement of § 1.401–1(b)(1)(i) requires a distribution, that requirement is deemed to be satisfied if distributions satisfy the minimum distribution incidental benefit requirement of section 401(a)(9)(G) and this section.

(e) *Annuity contracts.* Instead of satisfying this A–1, the minimum distribution requirement may be satisfied by the purchase of an annuity contract from an insurance company in accordance with A–4 of § 1.401(a)(9)–6T with the employee's entire individual account. If such an annuity is purchased after distributions are required to commence (the required beginning date, in the case of distributions commencing before death, or the date determined under A–3 of § 1.401(a)(9)–3, in the case of distributions commencing after death), payments under the annuity contract purchased will satisfy section 401(a)(9) for distribution calendar years after the calendar year of the purchase if payments under the annuity contract are made in accordance with § 1.401(a)(9)–6T. In such a case, payments under the annuity contract will be treated as distributions from the individual account for purposes of determining if the individual account satisfies section 401(a)(9) for the calendar year of the purchase. An employee may also purchase an annuity contract with a portion of the employee's account under the rules of A–2(a)(3) of § 1.401(a)(9)–8.

Q–2. If an employee's benefit is in the form of an individual account and, in any calendar year, the amount distributed exceeds the minimum required, will credit be given in subsequent calendar years for such excess distribution?

A–2. If, for any distribution calendar year, the amount distributed exceeds the minimum required, no credit will be given in subsequent calendar years for such excess distribution.

Q–3. What is the amount of the account of an employee used for determining the employee's required minimum distribution in the case of an individual account?

A–3. (a) In the case of an individual account, the benefit used in determining the required minimum distribution for a distribution calendar year is the account balance as of the last valuation date in the calendar year immediately preceding that distribution calendar year (valuation calendar year) adjusted in accordance with paragraphs (b) and (c) of this A–3.

(b) The account balance is increased by the amount of any contributions or forfeitures allocated to the account balance as of dates in the valuation calendar year after the valuation date. For this purpose, contributions that are allocated to the account balance as of dates in the valuation calendar year after the valuation date, but that are not actually made during the valuation calendar year, are permitted to be excluded.

(c) The account balance is decreased by distributions made in the valuation calendar year after the valuation date.

(d) If an amount is distributed by one plan and rolled over to another plan (receiving plan), A–2 of § 1.401(a)(9)–7 provides additional rules for determining the benefit and required minimum distribution under the receiving plan. If an amount is transferred from one plan (transferor plan) to another plan (transferee plan), A–3 and A–4 of § 1.401(a)(9)–7 provide additional rules for determining the amount of the required minimum distribution and the benefit under both the transferor and transferee plans.

Q–4. For required minimum distributions during an employee's lifetime, what is the applicable distribution period?

A–4. (a) *General rule*. Except as provided in paragraph (b) of this A–4, the applicable distribution period for required minimum distributions for distribution calendar years up to and including the distribution calendar year that includes the employee's date of death is determined using the Uniform Lifetime Table in A–2 of § 1.401(a)(9)–9 for the employee's age as of the employee's birthday in the relevant distribution calendar year. If an employee dies on or after the required beginning date, the distribution period applicable for calculating the amount that must be distributed during the distribution calendar year that includes the employee's death is determined as if the employee had lived throughout that year. Thus, a minimum required distribution, determined as if the employee had lived throughout that year, is required for the year of the employee's death and that amount must be distributed to a beneficiary to the extent it has not already been distributed to the employee.

(b) *Spouse is sole beneficiary*—(1) *General rule*. Except as otherwise provided in paragraph (b)(2) of this A–4, if the sole designated beneficiary of an employee is the employee's surviving spouse, for required minimum distributions during the employee's lifetime, the applicable distribution period is the longer of the distribution period determined in accordance with paragraph (a) of this A–4 or the joint life expectancy of the employee and spouse using the employee's and spouse's attained ages as of the employee's and the spouse's birthdays in the distribution calendar year. The spouse is sole designated beneficiary for purposes of determining the applicable distribution period for a distribution calendar year during the employee's lifetime only if the spouse is the sole beneficiary of the employee's entire interest at all times during the distribution calendar year.

(2) *Change in marital status*. If the employee and the employee's spouse are married on January 1 of a distribution calendar year, but do not remain married throughout that year (*i.e.*, the employee or the employee's spouse die or they become divorced during that year), the employee will not fail to have a spouse as the employee's sole beneficiary for that year merely because they are not married throughout that year. If an employee's spouse predeceases the employee, the spouse will not fail to be the employee's sole beneficiary for the distribution calendar year that includes the date of the spouse's death solely because, for the period remaining in that year after the spouse's death, someone other than the spouse is named as beneficiary. However, the change in beneficiary due to the death or divorce of the spouse will be effective for purposes of determining the applicable distribution period under section 401(a)(9) in the distribution calendar year following the distribution calendar year that includes the date of the spouse's death or divorce.

Q–5. For required minimum distributions after an employee's death, what is the applicable distribution period?

A–5. (a) *Death on or after the employee's required beginning date*. If an employee dies after distribution has begun as determined under A–6 of § 1.401(a)(9)–2 (generally on or after the employee's required beginning date), in order to satisfy section 401(a)(9)(B)(i), the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee's date of death is either —

(1) If the employee has a designated beneficiary as of the date determined under A–4 of § 1.401(a)(9)–4, the longer of —

(i) The remaining life expectancy of the employee's designated beneficiary determined in accordance with paragraph (c)(1) or (2) of this A–5; and

(ii) The remaining life expectancy of the employee determined in accordance with paragraph (c)(3) of this A–5; or

(2) If the employee does not have a designated beneficiary as of the date determined under A–4 of § 1.401(a)(9)–4, the remaining life expectancy of the employee determined in accordance with paragraph (c)(3) of this A–5.

(b) *Death before an employee's required beginning date*. If an employee dies before distribution has begun, as determined under A–5 of § 1.401(a)(9)–2 (generally before the employee's required beginning date), in order to satisfy section 401(a)(9)(B)(iii) or (iv) and the life expectancy rule described in A–1 of § 1.401(a)(9)–3, the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee's date of death is

determined in accordance with paragraph (c) of this A–5. See A–4 of § 1.401(a)(9)–3 to determine when the 5-year rule of in section 401(a)(9)(B)(ii) applies (*e.g.*, there is no designated beneficiary or the 5-year rule is elected or specified by plan provision).

(c) *Life expectancy*—(1) *Nonspouse designated beneficiary*. Except as otherwise provided in paragraph (c)(2), the applicable distribution period measured by the beneficiary's remaining life expectancy is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the calendar year of the employee's death. In subsequent calendar years, the applicable distribution period is reduced by one for each calendar year that has elapsed after the calendar year immediately following the calendar year of the employee's death.

(2) *Spouse designated beneficiary*. If the surviving spouse of the employee is the employee's sole beneficiary, the applicable distribution period is measured by the surviving spouse's life expectancy using the surviving spouse's birthday for each distribution calendar year after the calendar year of the employee's death up through the calendar year of the spouse's death. For calendar years after the calendar year of the spouse's death, the applicable distribution period is the life expectancy of the spouse using the age of the spouse as of the spouse's birthday in the calendar year of the spouse's death, reduced by one for each calendar year that has elapsed after the calendar year of the spouse's death.

(3) *No designated beneficiary*. If the employee does not have a designated beneficiary, the applicable distribution period measured by the employee's remaining life expectancy is the life expectancy of the employee using the age of the employee as of the employee's birthday in the calendar year of the employee's death. In subsequent calendar years, the applicable distribution period is reduced by one for each calendar year that has elapsed after the calendar year of the employee's death.

Q–6. What life expectancies must be used for purposes of determining required minimum distributions under section 401(a)(9)?

A–6. Life expectancies for purposes of determining required minimum distributions under section 401(a)(9) must be computed using the Single Life Table in A–1 of § 1.401(a)(9)–9 and the Joint and Last Survivor Table in A–3 of § 1.401(a)(9)–9.

Q–7. If an employee has more than one designated beneficiary, which designated beneficiary's life expectancy will be used to determine the applicable distribution period?

A–7. (a) *General rule*—(1) Except as otherwise provided in paragraph (c) of this A–7, if more than one individual is designated as a beneficiary with respect to an employee as of the applicable date for determining the designated beneficiary under A–4 of § 1.401(a)(9)–4, the designated beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the applicable distribution period.

(2) See A–3 of § 1.401(a)(9)–4 for rules that apply if a person other than an individual is designated as a beneficiary and see A–2 and A–3 of §1.401(a)(9)–8 for special rules that apply if an employee's benefit under a plan is divided into separate accounts and the beneficiaries with respect to a separate account differ from the beneficiaries of another separate account.

(b) *Contingent beneficiary*. Except as provided in paragraph (c)(1) of this A–7, if a beneficiary's entitlement to an employee's benefit after the employee's death is a contingent right, such contingent beneficiary is nevertheless considered to be a beneficiary for purposes of determining whether a person other than an individual is designated as a beneficiary (resulting in the employee being treated as having no designated beneficiary under the rules of A–3 of § 1.401(a)(9)–4) and which designated beneficiary has the shortest life expectancy under paragraph (a) of this A–7.

(c) *Successor beneficiary*—(1) A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy under paragraph (a) of this A–7, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death. Thus, for example, if the first beneficiary has a right to all income with respect to an employee's individual account during that beneficiary's life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary (any portion of the principal distributed during the life of the first income beneficiary to be held in trust until that first beneficiary's death), both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.

(2) If the individual beneficiary whose life expectancy is being used to calculate the distribution period dies after September 30 of the calendar year following the calendar year of the employee's death, such beneficiary's remaining life expectancy will be used to determine the distribution period without regard to the life expectancy of the subsequent beneficiary.

(3) This paragraph (c) is illustrated by the following examples:

Example 1. (i) Employer M maintains a defined contribution plan, Plan X. Employee A, an employee of M, died in 2005 at the age of 55, survived by spouse, B, who was 50 years old. Prior to A's death, M had established an account balance for A in Plan X. A's account balance is invested only in productive assets. A named a testamentary trust (Trust P) established under A's will as the beneficiary of all amounts payable from A's account in Plan X after A's death. A copy of the Trust P and a list of the trust beneficiaries were provided to the plan administrator of Plan X by October 31 of the calendar year following the calendar year of A's death. As of the date of A's death, the Trust P was irrevocable and was a valid trust under the laws of the state of A's domicile. A's account balance in Plan X was includible in A's gross estate under § 2039.

(ii) Under the terms of Trust P, all trust income is payable annually to B, and no one has the power to appoint Trust P principal to any person other than B. A's children, who are all younger than B, are the sole remainder beneficiaries of the Trust P. No other person has a beneficial interest in Trust P. Under the terms of the Trust P, B has the power, exercisable annually, to compel the trustee to withdraw from A's account balance in Plan X an amount equal to the income earned on the assets held in A's account in Plan X during the calendar year and to distribute that amount through Trust P to B. Plan X contains no prohibition on withdrawal from A's account of amounts in excess of the annual required minimum

distributions under section 401(a)(9). In accordance with the terms of Plan X, the trustee of Trust P elects, in order to satisfy section 401(a)(9), to receive annual required minimum distributions using the life expectancy rule in section 401(a)(9)(B)(iii) for distributions over a distribution period equal to B's life expectancy. If B exercises the withdrawal power, the trustee must withdraw from A's account under Plan X the greater of the amount of income earned in the account during the calendar year or the required minimum distribution. However, under the terms of Trust P, and applicable state law, only the portion of the Plan X distribution received by the trustee equal to the income earned by A's account in Plan X is required to be distributed to B (along with any other trust income.)

(iii) Because some amounts distributed from A's account in Plan X to Trust P may be accumulated in Trust P during B's lifetime for the benefit of A's children, as remaindermen beneficiaries of Trust P, even though access to those amounts are delayed until after B's death, A's children are beneficiaries of A's account in Plan X in addition to B and B is not the sole designated beneficiary of A's account. Thus the designated beneficiary used to determine the distribution period from A's account in Plan X is the beneficiary with the shortest life expectancy. B's life expectancy is the shortest of all the potential beneficiaries of the testamentary trust's interest in A's account in Plan X (including remainder beneficiaries). Thus, the distribution period for purposes of section 401(a)(9)(B)(iii) is B's life expectancy. Because B is not the sole designated beneficiary of the testamentary trust's interest in A's account in Plan X, the special rule in 401(a)(9)(B)(iv) is not available and the annual required minimum distributions from the account to Trust M must begin no later than the end of the calendar year immediately following the calendar year of A's death.

Example 2. (i) The facts are the same as *Example 1* except that the testamentary trust instrument provides that all amounts distributed from A's account in Plan X to the trustee while B is alive will be paid directly to B upon receipt by the trustee of Trust P.

(ii) In this case, B is the sole designated beneficiary of A's account in Plan X for purposes of determining the designated beneficiary under section 401(a)(9)(B)(iii) and (iv). No amounts distributed from A's account in Plan X to Trust P are accumulated in Trust P during B's lifetime for the benefit of any other beneficiary. Therefore, the residuary beneficiaries of Trust P are mere potential successors to B's interest in Plan X. Because B is the sole beneficiary of the testamentary trust's interest in A's account in Plan X, the annual required minimum distributions from A's account to Trust P must begin no later than the end of the calendar year in which A would have attained age 70½, rather than the calendar year immediately following the calendar year of A's death.

Q–8. If a portion of an employee's individual account is not vested as of the employee's required beginning date, how is the determination of the required minimum distribution affected?

A–8. If the employee's benefit is in the form of an individual account, the benefit used to determine the required minimum distribution for any distribution calendar year will be determined in accordance with A–1 of this section without regard to whether or not all of the employee's benefit is vested. If any portion of the employee's benefit is not vested, distributions will be treated as being paid from the vested portion of the benefit first. If, as of the end of a distribution calendar year (or as of the employee's required beginning date, in the case of the employee's first distribution calendar year), the total amount of the employee's vested benefit is less than the required minimum distribution for the calendar year, only the vested portion, if any, of the employee's benefit is required to be distributed by the end of the calendar year (or, if applicable, by the employee's required beginning date). However, the required minimum distribution for the subsequent distribution calendar year must be increased by the sum of amounts not distributed in prior calendar years because the employee's vested benefit was less than the required minimum distribution.

Q–9. Which amounts distributed from an individual account are taken into account in determining whether section 401(a)(9) is satisfied and which amounts are not taken into account in determining whether section 401(a)(9) is satisfied?

A–9. (a) *General rule*. Except as provided in paragraph (b), all amounts distributed from an individual account are distributions that are taken into account in determining whether section 401(a)(9) is satisfied, regardless of whether the amount is includible in income. Thus, for example, amounts that are excluded from income as recovery of investment in the contract under section 72 are taken into account for purposes of determining whether section 401(a)(9) is satisfied for a distribution calendar year. Similarly, amounts excluded from income as net unrealized appreciation on employer securities also are amounts distributed for purposes of determining if section 401(a)(9) is satisfied.

(b) *Exceptions*. The following amounts are not taken into account in determining whether the required minimum amount has been distributed for a calendar year:

(1) Elective deferrals and employee contributions that, pursuant to § 1.415–6(b)(6)(iv), are returned (together with the income allocable to these corrective distributions) as a result of the application of the section 415 limitations.

(2) Corrective distributions of excess deferrals as described in § 1.402(g)–1(e)(3), together with the income allocable to these distributions.

(3) Corrective distributions of excess contributions under a qualified cash or deferred arrangement under section 401(k)(8) and excess aggregate contributions under section 401(m)(6), together with the income allocable to these distributions.

(4) Loans that are treated as deemed distributions pursuant to section 72(p).

(5) Dividends described in section 404(k) that are paid on employer securities. (Amounts paid to the plan that, pursuant to section 404(k)(2)(A)(iii)(II), are included in the account balance and subsequently distributed from the account lose their character as dividends.)

(6) The costs of life insurance coverage (P.S. 58 costs).

(7) Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(b) of this chapter.

§ 1.401(a)(9)–6T Required minimum distributions for defined benefit plans and annuity contracts (temporary).

Q–1. How must distributions under a defined benefit plan be paid in order to satisfy section 401(a)(9)?

A–1. (a) *General rules*. In order to satisfy section 401(a)(9), except as otherwise provided in this A–1, distributions under a defined benefit plan must be paid in the form of periodic annuity payments for the employee's life (or the joint lives of the employee and beneficiary) or over a period certain that does not exceed the maximum length of the period certain determined in accordance with A–3 of this section. The interval between payments for the annuity must be uniform over the entire distribution period and must not exceed one year. Once payments have commenced over a period certain, the period certain may not be changed even if the period certain is shorter than the maximum permitted. Life annuity payments must satisfy the minimum distribution incidental benefit requirements of A–2 of this section. Except as otherwise provided in A–4(b) of this section,

all payments (life and period certain) also must either be nonincreasing or increase only in accordance with one of more of the following:

(1) With an annual percentage increase that does not exceed the annual percentage increase in a cost-of-living index that is based on prices of all items and issued by the Bureau of Labor Statistics;

(2) To the extent of the reduction in the amount of the employee's payments to provide for a survivor benefit upon death, but only if the beneficiary whose life was being used to determine the period described in section 401(a)(9)(A)(ii) over which payments were being made dies or is no longer the employee's beneficiary pursuant to a qualified domestic relations order within the meaning of section 414(p);

(3) To provide cash refunds of employee contributions upon the employee's death; or

(4) To pay increased benefits that result from a plan amendment.

(b) *Life annuity with period certain.* The annuity may be a life annuity (or joint and survivor annuity) with a period certain if the life (or lives, if applicable) and period certain each meet the requirements of paragraph (a) of this A–1. For purposes of this section, if distributions are permitted to be made over the lives of the employee and the designated beneficiary, references to a life annuity include a joint and survivor annuity.

(c) *Annuity commencement.* (1) Annuity payments must commence on or before the employee's required beginning date (within the meaning of A–2 of § 1.401(a)(9)–2). The first payment, which must be made on or before the employee's required beginning date, must be the payment which is required for one payment interval. The second payment need not be made until the end of the next payment interval even if that payment interval ends in the next calendar year. Similarly, in the case of distributions commencing after death in accordance with section 401(a)(9)(B)(iii) and (iv), the first payment, which must be made on or before the date determined under A–3(a) or (b) (whichever is applicable) of § 1.401(a)(9)–3, must be the payment which is required for one payment interval. Payment intervals are the periods for which payments are received, *e.g.*, bimonthly, monthly, semi-annually, or annually. All benefit accruals as of the last day of the first distribution calendar year must be included in the calculation of the amount of annuity payments for payment intervals ending on or after the employee's required beginning date.

(2) This paragraph (c) is illustrated by the following example:

Example. A defined benefit plan (Plan X) provides monthly annuity payments of $500 for the life of unmarried participants with a 10-year period certain. An unmarried, retired participant (A) in Plan X attains age 70½ in 2005. In order to meet the requirements of this paragraph, the first monthly payment of $500 must be made on behalf of A on or before April 1, 2006, and the payments must continue to be made in monthly payments of $500 thereafter for the life and 10-year period certain.

(d) *Lump sum distributions*. In the case of a lump sum distribution of an employee's entire accrued benefit during a distribution calendar year, the amount that is the required minimum distribution for the distribution calendar year (and thus not eligible for rollover under section 402(c)) is determined using either the rule in paragraph (d)(1) or (d)(2) of this A–1.

(1) The portion of the single sum distribution that is a required minimum distribution is determined by treating the single sum distribution as a distribution from an individual account plan and treating the amount of the single sum distribution as the employee's account balance as of the end of the relevant valuation calendar year. If the single sum distribution is being made in the calendar year containing the required beginning date and the required minimum distribution for the employee's first distribution calendar year has not been distributed, the portion of the single sum distribution that represents the required minimum distribution for the employee's first and second distribution calendar years is not eligible for rollover.

(2) The portion of the single sum distribution that is a required minimum distribution is permitted to be determined by expressing the employee's benefit as an annuity that would satisfy this section with an annuity starting date as of the first day of the distribution calendar year for which the required minimum distribution is being determined, and treating one year of annuity payments as the required minimum distribution for that year, and not eligible for rollover. If the single sum distribution is being made in the calendar year containing the required beginning date and the required minimum distribution for the employee's first distribution calendar year has not been made, the benefit must be expressed as an annuity with an annuity starting date as of the first day of the first distribution calendar year and the payments for the first two calendar years would be treated as required minimum distributions, and not eligible for rollover.

(e) *Death benefits*. The rules prohibiting increasing payments under an annuity apply to payments made upon the death of the employee. The preceding sentence will not apply to an increase due to an ancillary death benefit described in this paragraph (e). A death benefit with respect to an employee's benefit is an ancillary death benefit for purposes of this A–1 if—

(1) It is not paid as part of the employee's accrued benefit or under any optional form of the employee's benefit, and

(2) The death benefit, together with any other potential payments with respect to the employee's benefit that may be provided to a survivor, satisfy the incidental benefit requirement of § 1.401–1(b)(1)(i),

(f) *Additional guidance*. Additional guidance regarding how distributions under a defined benefit plan must be paid in order to satisfy section 401(a)(9) may be issued by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(b) of this chapter.

Q–2. How must distributions in the form of a life (or joint and survivor) annuity be made in order to satisfy the minimum distribution incidental benefit (MDIB) requirement of section 401(a)(9)(G) and the distribution component of the incidental benefit requirement of § 1.401–1(b)(1)(i)?

A–2. (a) *Life annuity for employee*. If the employee's benefit is payable in the form of a life annuity for the life of the employee satisfying section 401(a)(9) without regard to the MDIB requirement, the MDIB requirement of section 401(a)(9)(G) will be satisfied.

(b) *Joint and survivor annuity, spouse beneficiary*. If the employee's sole beneficiary, as of the annuity starting date for annuity payments, is the employee's

spouse and the distributions satisfy section 401(a)(9) without regard to the MDIB requirement, the distributions to the employee will be deemed to satisfy the MDIB requirement of section 401(a)(9)(G). For example, if an employee's benefit is being distributed in the form of a joint and survivor annuity for the lives of the employee and the employee's spouse and the spouse is the sole beneficiary of the employee, the amount of the periodic payment payable to the spouse is permitted to be 100 percent of the annuity payment payable to the employee regardless of the difference in the ages between the employee and the employee's spouse. The amount of the annuity payments must satisfy A–1 of this section (or A–4 of this section, if applicable).

(c) *Joint and survivor annuity, non-spouse beneficiary*—(1) *Explanation of rule*. If distributions commence under a distribution option that is in the form of a joint and survivor annuity for the joint lives of the employee and a beneficiary other than the employee's spouse, the minimum distribution incidental benefit requirement will not be satisfied as of the date distributions commence unless the distribution option provides that annuity payments to be made to the employee on and after the employee's required beginning date will satisfy the conditions of this paragraph (c). The periodic annuity payment payable to the survivor must not at any time on and after the employee's required beginning date exceed the applicable percentage of the annuity payment payable to the employee using the table in paragraph (c)(2) of this A–2. The applicable percentage is based on the excess of the age of the employee on the employee's birthday in a calendar year over the age of the beneficiary as of the beneficiary's birthday in that calendar year. Additionally, the amount of the annuity payments must satisfy A–1 of this section (or A–4 of this section, if applicable). In the case of an annuity which provides for increasing payments, the requirement of this paragraph (c) will be satisfied if the increase is determined in the same manner for the employee and the beneficiary.

(2) *Table*.

Excess of age of employee over age of beneficiary	Applicable percentage
10 years or less	100%
11	96%
12	93%
13	90%
14	87%
15	84%
16	82%
17	79%
18	77%
19	75%
20	73%
21	72%
22	70%
23	68%
24	67%
25	66%
26	64%
27	63%
28	62%
29	61%
30	60%
31	59%
32	59%
33	58%
34	57%
35	56%

Excess of age of employee over age of beneficiary	Applicable percentage
36	56%
37	55%
38	55%
39	54%
40	54%
41	53%
42	53%
43	53%
44 and greater	52%

(3) *Example*. This paragraph (c) is illustrated by the following example:

Example. Distributions commence on January 1, 2003, to an employee (Z), born March 1, 1937, after retirement at age 65. Z's daughter (Y), born February 5, 1967, is Z's beneficiary. The distributions are in the form of a joint and survivor annuity for the lives of Z and Y with payments of $500 a month to Z and upon Z's death of $500 a month to Y, *i.e.*, the projected monthly payment to Y is 100 percent of the monthly amount payable to Z. There is no provision under the option for a change in the projected payments to Y, and corresponding increase to Z, as of April 1, 2008, Z's required beginning date. Accordingly, under A–10 of this section, compliance with the rules of this section is determined as of the annuity starting date. Consequently, as of January 1, 2003 (the annuity starting date), the plan does not satisfy the MDIB requirement because, as of such date, the distribution option provides that, as of Z's required beginning date, the monthly payment to Y upon Z's death will exceed 60 percent of Z's monthly payment (the maximum percentage for a difference of ages of 30 years).

(d) *Period certain and annuity features*. If a distribution form includes a life annuity and a period certain, the amount of the annuity payments payable to the beneficiary need not be reduced during the period certain, but in the case of a joint and survivor annuity with a period certain, the amount of the annuity payments payable to the beneficiary must satisfy paragraph (c) of this A–2 after the expiration of the period certain.

(e) *Deemed satisfaction of incidental benefit rule*. Except in the case of distributions with respect to an employee's benefit that include an ancillary death benefit described in paragraph A–1(e) of this section, to the extent the incidental benefit requirement of § 1.401–1(b)(1)(i) requires a distribution, that requirement is deemed to be satisfied if distributions satisfy the minimum distribution incidental benefit requirement of this A–2. If the employee's benefits include an ancillary death benefit described in paragraph A–1(e) of this section, the benefits must be distributed in accordance with the incidental benefit requirement described in § 1.401–1(b)(1)(i) and must also satisfy the minimum distribution incidental benefit requirement of this A–2.

Q–3. How long is a period certain under a defined benefit plan permitted to extend?

A–3. (a) *Distributions commencing during the employee's life*. The period certain for any annuity distributions commencing during the life of the employee with an annuity starting date on or after the employee's required beginning date generally is not permitted to exceed the applicable distribution period for the employee (determined in accordance with the Uniform Lifetime Table in A–2 of § 1.401(a)(9)–9) for the calendar year that contains the annuity starting date. See A–10 for the rule for annuity payments with an annuity starting date before the required beginning date. However, if the employee's sole beneficiary is the employee's spouse and the annuity provides only a period certain and no life annuity, the period certain is permitted to be as long as the joint life and last survivor expectancy of the employee and the employee's spouse, if longer than the applicable distribution period for the employee.

(b) *Distributions commencing after the employee's death*. (1) If annuity distributions commence after the death of the employee under the life expectancy rule (under section 401(a)(9)(B)(iii) or (iv)), the period certain for any distributions commencing after death cannot exceed the applicable distribution period determined under A–5(b) of § 1.401(a)(9)–5 for the distribution calendar year that contains the annuity starting date.

(2) If the annuity starting date is in a calendar year before the first distribution calendar year, the period certain may not exceed the life expectancy of the designated beneficiary using the beneficiary's age in the year that contains the annuity starting date.

Q–4. Will a plan fail to satisfy section 401(a)(9) merely because distributions are made from an annuity contract which is purchased from an insurance company?

A–4. (a) *General rule*. A plan will not fail to satisfy section 401(a)(9) merely because distributions are made from an annuity contract which is purchased with the employee's benefit by the plan from an insurance company, as long as the payments satisfy the requirements of this section. If the annuity contract is purchased after the required beginning date, the first payment interval must begin on or before the purchase date and the payment required for one payment interval must be made no later than the end of such payment interval. If the payments actually made under the annuity contract do not meet the requirements of section 401(a)(9), the plan fails to satisfy section 401(a)(9).

(b) *Permitted increases*. In the case of an annuity contract purchased from an insurance company with an employee's account balance under a defined contribution plan or under a section 403(a) annuity plan, if the total future expected payments (determined in accordance with paragraph (c)(3) of this A–4) exceed the

account value being annuitized, the payments under the annuity will not fail to satisfy the nonincreasing payment requirement in A–1(a) of this section merely because the payments are increased in accordance with one or more of the following —

(1) By a constant percentage, applied not less frequently than annually;

(2) To provide a payment upon the death of the employee equal to the excess of the account value being annuitized over the total of payments before the death of the employee.

(3) As a result of dividend payments or other payments that result from actuarial gains, but only if actuarial gain is measured no less frequently than annually and the resulting dividend payments or other payments are either paid no later than the year following the year for which the actuarial experience is measured or paid in the same form as the payment of the annuity over the remaining period of the annuity (beginning no later than the year following the year for which the actuarial experience is measured);

(4) As a final payment under the annuity contract, but only if the payment does not exceed the total future expected payments as of the date of the payment; or

(5) As a partial distribution under the contract, but only if the contract provides for a final payment as of the date of partial distribution that satisfies paragraph (b)(4) of this A–4 and the future payments under the contract are reduced by multiplying the otherwise applicable future payments by a fraction, the numerator of which is the excess of that final payment over the amount of the partial distribution and the denominator of which is the amount of that final payment. For the purpose of determining this ratio, the denominator is reduced by the amount of any regularly scheduled payment due on the date of the partial distribution.

(c) *Definitions*. For purposes of this A–4, the following definitions apply —

(1) Account value being annuitized means the value of the employee's entire interest (within the meaning of A–12 of this section) being annuitized (valued as of the date annuity payments commence) or, in the case of a defined contribution plan, the value of the employee's account balance used to purchase an immediate annuity under the contract.

(2) Actuarial gain means the difference between the actuarial assumptions used in pricing (*i.e.*, investment return, mortality, expense, and other similar assumptions) and the actual experience with respect to those assumptions. Actuarial gain also includes differences between the actuarial assumptions used in pricing when an annuity was purchased and actuarial assumptions used in pricing annuities at the time the actuarial gain is determined.

(3) Total future expected payments means the total future payments to be made under the annuity contract as of the date of the determination, calculated using the Single Life Table in A–1 of § 1.401(a)(9)–9 (or, if applicable, the Joint and Last Survivor Table in A–3 of in § 1.401(a)(9)–9) for annuitants who are still alive, without regard to any increases in annuity payments after the date of determination, and taking into account any remaining period certain.

(d) *Examples*. This A–4 is illustrated by the following examples:

Example 1. A participant (Z1) in defined contribution plan X attains age 70 on March 5, 2005, and thus, attains age 70½ in 2005. Z1 elects to purchase annuity Contract Y1 from Insurance Company W in 2005. Contract Y1 is a life annuity contract with a 10–year period certain. Contract Y1 provides for an initial annual payment calculated with an assumed interest rate (AIR) of 3 percent. Subsequent payments are determined by multiplying the prior year's payment by a fraction the numerator of which is 1 plus the actual return on the separate account assets underlying Contract Y1 since the preceding payment and the denominator of which is 1 plus the AIR during that period. The value of Z1's account balance in Plan X at the time of purchase is $105,000, and the purchase price of Contract Y1 is $105,000. Contract Y1 provides Z1 with an initial payment of $7,200 at the time of purchase in 2005. The total future expected payments to Z1 under Contract Y1 are $122,400, calculated as the initial payment of $7,200 multiplied by the age 70 life expectancy of 17. Because the total future expected payments on the purchase date exceed the account value used to purchase Contract Y1 and payments may only increase as a result of actuarial gain, with such increases, beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity, distributions received by Z1 from Contract Y1 meet the requirements under paragraph (b)(3) of this A–4.

Example 2. A participant (Z2) in defined contribution plan X attains age 70 on May 1, 2005, and thus, attains age 70½ in 2005. Z2 elects to purchase annuity Contract Y2 from Insurance Company W in 2005. Contract Y2 is a participating life annuity contract with a 10-year period certain. Contract Y2 provides for level annual payments with dividends paid in a lump sum in the year after the year for which the actuarial experience is measured or paid out levelly beginning in the year after the year for which the actuarial gain is measured over the remaining lifetime and period certain, *i.e.*, the period certain ends at the same time as the original period certain. Dividends are determined annually by the Board of Directors of Company W based upon a comparison of actual actuarial experience to expected actuarial experience in the past year. The value of Z2's account balance in Plan X at the time of purchase is $265,000, and the purchase price of Contract Y2 is $265,000. Contract Y2 provides Z2 with an initial payment of $16,000 in 2005. The total future expected payments to Z2 under Contract Y2 are calculated as the annual initial payment of $16,000 multiplied by the age 70 life expectancy of 17 for a total of $272,000. Because the total future expected payments on the purchase date exceeds the account value used to purchase Contract Y2 and payments may only increase as a result of actuarial gain, with such increases, beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity, distributions received by Z2 from Contract Y2 meet the requirements under paragraph (b)(3) of this A–4.

Example 3. The facts are the same as in *Example 2* except that the annuity provides a dividend accumulation option under which Z2 may defer receipt of the dividends to a time selected by Z2. Because the dividend accumulation option permits dividends to be paid later than the end of the year following the year for which the actuarial experience is measured or as a stream of payments that only increase as a result of actuarial gain, with such increases beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity in *Example 2*, the dividend accumulation option does not meet the requirements of paragraph (b)(3) of this A–4. Neither does the dividend accumulation option fit within any of the other increases described in paragraph (b) of this A–4. Accordingly, the dividend accumulation option causes the contract, and consequently any distributions from the contract, to fail to meet the requirements of this A–4 and thus fail to satisfy the requirements of section 401(a)(9).

Example 4. The facts are the same as in *Example 2* except that the annuity provides an option under which actuarial gain under the contract is used to provide additional death benefit protection for Z2. Because this option permits payments as a result of actuarial gain to be paid later than the end of the year following the year for which the actuarial experience is measured or as a stream of payments that only increase as a result of actuarial gain, with such increases beginning no later than the next year, paid in the same form as the payment of the annuity over the remaining period of the annuity in *Example 2*, the option does not meet the requirements of paragraph (b)(3) of this A–4. Neither does the option fit within any of the other increases described in paragraph (b) of this A–4. Accordingly, the addition of the option causes the contract, and consequently any distributions from the contract, to fail to meet the requirements of this A–4 and thus fail to satisfy the requirements of section 401(a)(9).

Example 5. A participant (Z3) in defined contribution plan X attains age 70½ in 2005. Z3 elects to

purchase annuity contract Y3 from Insurance Company W. Contract Y3 is a life annuity contract with a 20-year period certain (which does not exceed the maximum period certain permitted under A–3(a) of this section) with fixed annual payments increasing 3 percent each year. The value of Z3's account balance in Plan X at the time of purchase is $110,000, and the purchase price of Contract Y3 is $110,000. Contract Y3 provides Z3 with an initial payment of $6,000 at the time of purchase in 2005. The total future expected payments to Z3 under Contract Y3 are $120,000, calculated as the initial annual payment of $6,000 multiplied by the period certain of 20 years. Because the total future expected payments on the purchase date exceed the account value used to purchase Contract Y3 and payments only increase as a constant percentage applied not less frequently than annually, distributions received by Z3 from Contract Y3 meet the requirements under paragraph (b)(1) of this A–4.

Example 6. The facts are the same as in *Example 5* except that the initial payment is $5,400 and the annual rate of increase is 4 percent. In this example, the total future expected payments are $108,000, calculated as the initial payment of $5,400 multiplied by the period certain of 20 years. Because the total future expected payments are less than the account value of $110,000 used to purchase Contract Y3, distributions received by Z3 do not meet the requirements under paragraph (b) of this A–4 and thus fail to meet the requirements of section 401(a)(9).

Example 7. (i) A participant (Z4) in defined contribution Plan X attains age 78 in 2005. Z4 elects to purchase Contract Y4 from Insurance Company W. Contract Y4 provides for fixed annual payments for 20 years (which does not exceed the maximum period certain permitted under A–3(a) of this section) and provides that, on any payment date, before receiving his payment due on that date, Z4 may cancel Contract Y4 and receive as a final payment an amount equal to his remaining payments discounted with interest at 4 percent. The value of Z4's account balance in Plan X at the time of purchase is $500,000, and the purchase price of Contract Y4 is $500,000. Contract Y4 provides Z4 with an initial payment in 2005 of $35,376.

(ii) Under Contract Y4, the amount that Z4 could receive upon cancellation of Contract Y4 as a final payment, for all possible cancellation dates, will always be less than the total future expected payments on such cancellation date. This is so because the total future expected payments on any such cancellation date is equal to the remaining payments on such date, not discounted, an amount always greater than the final payment amount of these same remaining payments, discounted at 4 percent.

(iii) The total future expected payments to Z4 under Y4 are $707,520, calculated as the annualized initial payment of $35,376 multiplied by the period certain of 20 years. Because the total future expected payments on the purchase date exceed the account value used to purchase Contract Y4 and it is not possible for a final payment under Contract Y4 to ever exceed the total future expected payments on the day of such final payment, distributions received by Z4 under Contract Y4 meet the requirements under paragraph (b)(4) of this A–4.

(iv) As an illustration of the above, if Participant Z4 were to elect to cancel Contract Y4 on the day he was due to receive his eleventh payment, his contractual final payment would be $298,408 (including the $35,376 he was due to receive on that day) which is less than his total future expected payments on that date ($353,760). These amounts are determined as follows. On the day Z4 was to receive his eleventh payment, Z4 was entitled to receive ten future payments of $35,376 (including the payment he was due to receive on that day). The discounted value of an annuity of ten payments of $35,376, with the first payment due on the date of the calculation of the discounted value, and a discount rate of 4 percent, is $298,408. The product of the payment amount of $35,376 multiplied by 10, the number of future payments to which Z4 would be entitled on the day Z4 was to receive the eleventh payment, is $353,760.

Example 8. (i) The facts are the same as in *Example 7* except that the annuity provides an option for partial distributions of less than the final payment amount (the maximum distribution), with payments following such a partial distribution reduced by multiplying the otherwise applicable future payments by a fraction, the numerator of which is the excess of the final payment amount over the amount of the partial distribution and the denominator of which is the amount of that final payment. For the purposes of determining this ratio, the denominator is reduced by the amount of any regularly scheduled payment due on the date of partial distribution. This partial distribution option meets the requirements of paragraph (b)(5) of this A–4.

(ii) To illustrate the workings of this partial distribution option, assume Z4 takes a distribution of $100,000 on the date he was to receive his eleventh payment of $35,376. In such a case, under this partial distribution option, his remaining nine payments, absent any other extraordinary distributions, will be reduced to $26,685. This amount is determined as follows. The numerator of the ratio described in the paragraph above is equal to $198,408 (that is, the excess of a total distribution of $298,408 over the partial distribution of $100,000). The denominator of the ratio described in the paragraph above is equal to $263,032 (that is, the maximum distribution on the date of the partial distribution of $298,408 (see *Example 6*) less the regularly scheduled payment of $35,376). Thus, future payments must be multiplied by 75.43 percent (that is, $198,408 divided by $263,032). Thus, his future payments must be $26,685 (that is, $35,376 multiplied by 75.43 percent).

Example 9. (i) A participant (Z5) in defined contribution plan X attains age 70½ in 2005. Z5 elects to purchase annuity Contract Y5 from Insurance Company W in 2005. Contract Y5 is a participating life annuity contract with a 20-year period certain. Contract Y5 provides an initial payment at the time of purchase of 5 percent of the purchase price, a second payment one year from the time of purchase of two percent of the purchase price, and 18 succeeding annual payments each increasing at a constant percentage rate of 16 percent from the preceding payment.

(ii) Contract Y5 fails to meet the requirements of paragraph (b) of this A–4, and thus fails to satisfy the requirements of section 401(a)(9), because the expected total payments without regard to any increases in the annuity payment is only 43 percent of the purchase price (that is, an amount not exceeding the account value used to purchase the annuity), calculated as 5 percent of the purchase price in year one and two percent of the purchase price in each of years two through twenty (or, .05 multiplied by 1 year plus .02 multiplied by 19 years).

Q–5. In the case of annuity distributions under a defined benefit plan, how must additional benefits that accrue after the employee's first distribution calendar year be distributed in order to satisfy section 401(a)(9)?

A–5. (a) In the case of annuity distributions under a defined benefit plan, if any additional benefits accrue in a calendar year after the employee's first distribution calendar year, distribution of the amount that accrues in a calendar year must commence in accordance with A–1 of this section beginning with the first payment interval ending in the calendar year immediately following the calendar year in which such amount accrues.

(b) A plan will not fail to satisfy section 401(a)(9) merely because there is an administrative delay in the commencement of the distribution of the additional benefits accrued in a calendar year, provided that the actual payment of such amount commences as soon as practicable. However, payment must commence no later than the end of the first calendar year following the calendar year in which the additional benefit accrues, and the total amount paid during such first calendar year must be no less than the total amount that was required to be paid during that year under A–5(a) of this section.

Q–6. If a portion of an employee's benefit is not vested as of December 31 of a distribution calendar year, how is the determination of the required minimum distribution affected?

A–6 In the case of annuity distributions from a defined benefit plan, if any portion of the employee's benefit is not vested as of December 31 of a distribution calendar year, the portion that is not vested as of such date will be treated as not having accrued for purposes of determining the required minimum distribution for that distribution calendar year. When an additional portion of the employee's benefit becomes vested, such portion will be treated as an additional accrual. See A–5 of this section for the rules for distributing benefits which accrue under a

defined benefit plan after the employee's first distribution calendar year.

Q–7. If an employee (other than a 5-percent owner) retires after the calendar year in which the employee attains age 70½, for what period must the employee's accrued benefit under a defined benefit plan be actuarially increased?

A–7. (a) *Actuarial increase starting date*. If an employee (other than a 5-percent owner) retires after the calendar year in which the employee attains age 70½, in order to satisfy section 401(a)(9)(C)(iii), the employee's accrued benefit under a defined benefit plan must be actuarially increased to take into account any period after age 70½ in which the employee was not receiving any benefits under the plan. The actuarial increase required to satisfy section 401(a)(9)(C)(iii) must be provided for the period starting on the April 1 following the calendar year in which the employee attains age 70½, or January 1, 1997, if later.

(b) *Actuarial increase ending date*. The period for which the actuarial increase must be provided ends on the date on which benefits commence after retirement in an amount sufficient to satisfy section 401(a)(9).

(c) *Nonapplication to plan providing same required beginning date for all employees*. If, as permitted under A–2(e) of § 1.401(a)(9)–2, a plan provides that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 70½ (regardless of whether the employee is a 5-percent owner) and the plan makes distributions in an amount sufficient to satisfy section 401(a)(9) using that required beginning date, no actuarial increase is required under section 401(a)(9)(C)(iii).

(d) *Nonapplication to governmental and church plans*. The actuarial increase required under this A–7 does not apply to a governmental plan (within the meaning of section 414(d)) or a church plan. For purposes of this paragraph, the term *church plan* means a plan maintained by a church for church employees, and the term *church* means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

Q–8. What amount of actuarial increase is required under section 401(a)(9)(C)(iii)?

A–8. In order to satisfy section 401(a)(9)(C)(iii), the retirement benefits payable with respect to an employee as of the end of the period for actuarial increases (described in A–7 of this section) must be no less than: the actuarial equivalent of the employee's retirement benefits that would have been payable as of the date the actuarial increase must commence under paragraph (a) of A–7 of this section if benefits had commenced on that date; plus the actuarial equivalent of any additional benefits accrued after that date; reduced by the actuarial equivalent of any distributions made with respect to the employee's retirement benefits after that date. Actuarial equivalence is determined using the plan's assumptions for determining actuarial equivalence for purposes of satisfying section 411.

Q–9. How does the actuarial increase required under section 401(a)(9)(C)(iii) relate to the actuarial increase required under section 411?

A–9. In order for any of an employee's accrued benefit to be nonforfeitable as required under section 411, a defined benefit plan must make an actuarial adjustment to an accrued benefit the payment of which is deferred past normal retirement age. The only exception to this rule is that generally no actuarial adjustment is required to reflect the period during which a benefit is suspended as permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA). The actuarial increase required under section 401(a)(9)(C)(iii) for the period described in A–7 of this section is generally the same as, and not in addition to, the actuarial increase required for the same period under section 411 to reflect any delay in the payment of retirement benefits after normal retirement age. However, unlike the actuarial increase required under section 411, the actuarial increase required under section 401(a)(9)(C)(iii) must be provided even during any period during which an employee's benefit has been suspended in accordance with ERISA section 203(a)(3)(B).

Q–10. What rule applies if distributions commence to an employee on a date before the employee's required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A–1 (and if applicable A–4) of this section?

A–10. (a) *General rule*. If distributions commence to an employee on an irrevocable basis (except for acceleration) on a date before the employee's required beginning date over a period permitted under section 401(a)(9)(A)(ii) and the distribution form is an annuity under which distributions are made in accordance with the provisions of A–1 (and, if applicable, A–4) of this section, the annuity starting date will be treated as the required beginning date for purposes of applying the rules of this section and § 1.401(a)(9)–2. Thus, for example, the designated beneficiary distributions will be determined as of the annuity starting date. Similarly, if the employee dies after the annuity starting date but before the required beginning date determined under A–2 of § 1.401(a)(9)–2, after the employee's death, the remaining portion of the employee's interest must continue to be distributed in accordance with this section over the remaining period over which distributions commenced (single or joint lives or period certain, as applicable). The rules in § 1.401(a)(9)–3 and section 401(a)(9)(B)(ii) or (iii) and (iv) do not apply.

(b) *Period certain*. If as of the employee's birthday in the year that contains the annuity starting date, the age of the employee is under 70, the following rule applies in applying the rule in paragraph (a) of A–3 of this section. The applicable distribution period for the employee (determined in accordance with the Uniform Lifetime Table in A–2 of § 1.401(a)(9)–9) is the distribution period for age 70 using the Uniform Lifetime Table in A–2 of § 1.401(a)(9)–9 plus the excess of 70 over age of the employee as of the employee's birthday in the year that contains the annuity starting date.

Q–11. What rule applies if distributions commence on an irrevocable basis (except for acceleration) to the surviving

spouse of an employee over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A–1 (and if applicable A–4) of this section?

A–11. If distributions commence to the surviving spouse of an employee on an irrevocable basis (except for acceleration) over a period permitted under section 401(a)(9)(B)(iii)(II) before the date on which distributions are required to commence and the distribution form is an annuity under which distributions are made as of the date distributions commence in accordance with the provisions of A–1 (and if applicable A–4) of this section, distributions will be considered to have begun on the actual commencement date for purposes of section 401(a)(9)(B)(iv)(II). Consequently, in such case, A–5 of § 1.401(a)(9)–3 and section 401(a)(9)(B)(ii) and (iii) will not apply upon the death of the surviving spouse as though the surviving spouse were the employee. Instead, the annuity distributions must continue to be made, in accordance with the provisions of A–1 (and if applicable A–4) of this section over the remaining period over which distributions commenced (single life or period certain, as applicable).

Q–12. In the case of an annuity contract under an individual account plan from which annuity payments have not commenced to on an irrevocable basis (except for acceleration), how is section 401(a)(9) satisfied with respect to the employee's or beneficiary's entire interest under the annuity contract for the period prior to the date annuity payments so commence?

A–12. Prior to the date that annuity payments commence on an irrevocable basis (except for acceleration) under an individual account plan from an annuity contract, the interest of an employee or beneficiary under that contract is treated as an individual account for purposes of section 401(a)(9). Thus, the required minimum distribution for any year with respect to that interest is determined under § 1.401(a)(9)–5 rather than this section. For purposes of applying the rules in § 1.401(a)(9)–5, the entire interest under the annuity contract as of December 31 of the relevant valuation calendar year is treated as the account balance for the valuation calendar year described in A–3 of § 1.401(a)(9)–5. The entire interest under an annuity contract is the dollar amount credited to the employee or beneficiary under the contract plus the actuarial value of any other benefits (such as minimum survivor benefits) that will be provided under the contract. See A–1 of § 1.401(a)(9)–5 for rules relating to the satisfaction of section 401(a)(9) in the year that annuity payments commence and A–2(a)(3) of § 1.401(a)(9)–8.

§ 1.401(a)(9)–7 Rollovers and transfers.

Q–1. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan, is the required minimum distribution under the distributing plan affected by the rollover?

A–1. No, if an amount is distributed by one plan and is rolled over to another plan, the amount distributed is still treated as a distribution by the distributing plan for purposes of section 401(a)(9), notwithstanding the rollover. See A–1 of § 1.402(c)–2 for the definition of a rollover and A–7 of § 1.402(c)–2 for rules for determining the portion of any distribution that is not eligible for rollover because it is a required minimum distribution.

Q–2. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), how are the benefit and the required minimum distribution under the receiving plan affected?

A–2. If an amount is distributed by one plan (distributing plan) and is rolled over to another plan (receiving plan), the benefit of the employee under the receiving plan is increased by the amount rolled over for purposes of determining the required minimum distribution for the calendar year immediately following the calendar year in which the amount rolled over is distributed. If the amount rolled over is received after the last valuation date in the calendar year under the receiving plan, the benefit of the employee as of such valuation date, adjusted in accordance with A–3 of § 1.401(a)(9)–5, will be increased by the rollover amount valued as of the date of receipt. In addition, if the amount rolled over is received in a different calendar year from the calendar year in which it is distributed, the amount rolled over is deemed to have been received by the receiving plan in the calendar year in which it was distributed.

Q–3. In the case of a transfer of an amount of an employee's benefit from one plan (transferor plan) to another plan (transferee plan), are there any special rules for satisfying section 401(a)(9) or determining the employee's benefit under the transferor plan?

A–3. (a) In the case of a transfer of an amount of an employee's benefit from one plan (transferor plan) to another (transferee plan), the transfer is not treated as a distribution by the transferor plan for purposes of section 401(a)(9). Instead, the benefit of the employee under the transferor plan is decreased by the amount transferred. However, if any portion of an employee's benefit is transferred in a distribution calendar year with respect to that employee, in order to satisfy section 401(a)(9), the transferor plan must determine the amount of the required minimum distribution with respect to that employee for the calendar year of the transfer using the employee's benefit under the transferor plan before the transfer. Additionally, if any portion of an employee's benefit is transferred in the employee's second distribution calendar year but on or before the employee's required beginning date, in order to satisfy section 401(a)(9), the transferor plan must determine the amount of the minimum distribution requirement for the employee's first distribution calendar year based on the employee's benefit under the transferor plan before the transfer. The transferor plan may satisfy the minimum distribution requirement for the calendar year of the transfer (and the prior year if applicable) by segregating the amount which must be distributed from the employee's benefit and not transferring that amount. Such amount may be retained by the transferor plan and must be distributed on or before the date required under section 401(a)(9).

(b) For purposes of determining any required minimum distribution for the calendar year immediately following the calendar year in which the transfer occurs, in the case of a transfer after the last valuation date for the calendar year of

the transfer under the transferor plan, the benefit of the employee as of such valuation date, adjusted in accordance with A–3 of § 1.401(a)(9)–5, will be decreased by the amount transferred, valued as of the date of the transfer.

Q–4. If an amount of an employee's benefit is transferred from one plan (transferor plan) to another plan (transferee plan), how are the benefit and the required minimum distribution under the transferee plan affected?

A–4. In the case of a transfer from one plan (transferor plan) to another (transferee plan), the benefit of the employee under the transferee plan is increased by the amount transferred in the same manner as if it were a plan receiving a rollover contribution under A–2 of this section.

Q–5. How is a spinoff, merger or consolidation (as defined in § 1.414(*l*)–1) treated for purposes of determining an employee's benefit and required minimum distribution under section 401(a)(9)?

A–5. For purposes of determining an employee's benefit and required minimum distribution under section 401(a)(9), a spinoff, a merger, or a consolidation (as defined in § 1.414(*l*)–1) will be treated as a transfer of the benefits of the employees involved. Consequently, the benefit and required minimum distribution of each employee involved under the transferor and transferee plans will be determined in accordance with A–3 and A–4 of this section.

§ 1.401(a)(9)–8 Special rules.

Q–1. What distribution rules apply if an employee is a participant in more than one plan?

A–1. If an employee is a participant in more than one plan, the plans in which the employee participates are not permitted to be aggregated for purposes of testing whether the distribution requirements of section 401(a)(9) are met. The distribution of the benefit of the employee under each plan must separately meet the requirements of section 401(a)(9). For this purpose, a plan described in section 414(k) is treated as two separate plans, a defined contribution plan to the extent benefits are based on an individual account and a defined benefit plan with respect to the remaining benefits.

Q–2. If an employee's benefit under a defined contribution plan is divided into separate accounts (or under a defined benefit plan is divided into segregated shares), do the distribution rules in section 401(a)(9) and these regulations apply separately to each separate account?

A–2. (a) *Defined contribution plan.* (1) Except as otherwise provided in this A–2, if an employee's benefit under a defined contribution plan is divided into separate accounts under the plan, the separate accounts will be aggregated for purposes of satisfying the rules in section 401(a)(9). Thus, except as otherwise provided in this A–2, all separate accounts, including a separate account for employee contributions under section 72(d)(2), will be aggregated for purposes of section 401(a)(9).

(2) If the employee's benefit in a defined contribution plan is divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts of the employee under the plan, for years subsequent to the calendar year containing the date on which the separate accounts were established, or date of death if later, such separate account under the plan is not aggregated with the other separate accounts under the plan in order to determine whether the distributions from such separate account under the plan satisfy section 401(a)(9). Instead, the rules in section 401(a)(9) separately apply to such separate account under the plan. However, the applicable distribution period for each such separate account is determined disregarding the other beneficiaries of the employee's benefit only if the separate account is established on a date no later than the last day of the year following the calendar year of the employee's death. For example, if, in the case of a distribution described in section 401(a)(9)(B)(iii) and (iv), the only beneficiary of a separate account under the plan established on a date no later than the end of the year following the calendar year of the employee's death is the employee's surviving spouse, and beneficiaries other than the surviving spouse are designated with respect to the other separate accounts with respect to the employee, distribution of the spouse's separate account under the plan need not commence until the date determined under the first sentence in A–3(b) of § 1.401(a)(9)–3, even if distribution of the other separate accounts under the plan must commence at an earlier date. Similarly, in the case of a distribution after the death of an employee to which section 401(a)(9)(B)(i) does not apply, distribution from a separate account of an employee established on a date no later than the end of the year following the year of the employee's death may be made over a beneficiary's life expectancy in accordance with section 401(a)(9)(B)(iii) and (iv) even though distributions from other separate accounts under the plan with different beneficiaries are being made in accordance with the 5-year rule in section 401(a)(9)(B)(ii).

(3) A portion of an employee's account balance under a defined contribution plan is permitted to be used to purchase an annuity contract while another portion stays in the account. In that case, the remaining account under the plan must be distributed in accordance with § 1.401(a)(9)–5 in order to satisfy section 401(a)(9) and the annuity payments under the annuity contract must satisfy § 1.401(a)(9)–6T in order to satisfy section 401(a)(9).

(b) *Defined benefit plan.* The rules of paragraph (a)(2) and (3) of this A–2 also apply to benefits under a defined benefit plan where the benefits under the plan are separated into separate identifiable components which are separately distributed.

Q–3. What are separate accounts for purposes of section 401(a)(9)?

A–3. For purposes of section 401(a)(9), separate accounts in an employee's account are separate portions of an employee's benefit reflecting the separate interests of the employee's beneficiaries under the plan as of the date of the employee's death for which separate accounting is maintained. The separate accounting must allocate all post-death investment gains and losses, contributions, and forfeitures, for the period prior to the establishment of the separate accounts on a *pro rata* basis in a reasonable and consistent manner among the separate accounts. However, once the separate accounts are actually established, the separate accounting can provide for separate investments for each separate account under which gains and losses from the investment of the account are

only allocated to that account, or investment gain or losses can continue to be allocated among the separate accounts on a pro rata basis. A separate accounting must allocate any post-death distribution to the separate account of the beneficiary receiving that distribution.

Q–4. If a distribution is required to be made to an employee by section 401(a)(9)(A) or is required to be made to a surviving spouse under section 401(a)(9)(B), must the distribution be made even if the employee, or spouse where applicable, fails to consent to a distribution while a benefit is immediately distributable?

A–4. Yes, section 411(a)(11) and section 417(e) (see §§ 1.411(a)(11)–1(c)(2) and 1.417(e)–1(c)) require employee and spousal consent to certain distributions of plan benefits while such benefits are immediately distributable. If an employee's normal retirement age is later than the employee's required beginning date and, therefore, benefits are still immediately distributable, the plan must, nevertheless, distribute plan benefits to the employee (or where applicable, to the spouse) in a manner that satisfies the requirements of section 401(a)(9). Section 401(a)(9) must be satisfied even though the employee (or spouse, where applicable) fails to consent to the distribution. In such a case, the plan may distribute in the form of a qualified joint and survivor annuity (QJSA) or in the form of a qualified preretirement survivor annuity (QPSA), as applicable, and the consent requirements of sections 411(a)(11) and 417(e) are deemed to be satisfied if the plan has made reasonable efforts to obtain consent from the employee (or spouse if applicable) and if the distribution otherwise meets the requirements of section 417. If, because of section 401(a)(11)(B), the plan is not required to distribute in the form of a QJSA to a employee or a QPSA to a surviving spouse, the plan may distribute the required minimum distribution amount to satisfy section 401(a)(9) and the consent requirements of sections 411(a)(11) and 417(e) are deemed to be satisfied if the plan has made reasonable efforts to obtain consent from the employee (or spouse if applicable) and if the distribution otherwise meets the requirements of section 417.

Q–5. Who is an employee's spouse or surviving spouse for purposes of section 401(a)(9)?

A–5. Except as otherwise provided in A–6(a) of this section (in the case of distributions of a portion of an employee's benefit payable to a former spouse of an employee pursuant to a qualified domestic relations order), for purposes of section 401(a)(9), an individual is a spouse or surviving spouse of an employee if such individual is treated as the employee's spouse under applicable state law. In the case of distributions after the death of an employee, for purposes of determining whether, under the life expectancy rule in section 401(a)(9)(B)(iii) and (iv), the provisions of section 401(a)(9)(B)(iv) apply, the spouse of the employee is determined as of the date of death of the employee.

Q–6. In order to satisfy section 401(a)(9), are there any special rules which apply to the distribution of all or a portion of an employee's benefit payable to an alternate payee pursuant to a qualified domestic relations order as defined in section 414(p) (QDRO)?

A–6. (a) A former spouse to whom all or a portion of the employee's benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the employee for purposes of section 401(a)(9), including the minimum distribution incidental benefit requirement, regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of sections 401(a)(11) and 417.

(b)(1) If a QDRO provides that an employee's benefit is to be divided and a portion is to be allocated to an alternate payee, such portion will be treated as a separate account (or segregated share) which separately must satisfy the requirements of section 401(a)(9) and may not be aggregated with other separate accounts (or segregated shares) of the employee for purposes of satisfying section 401(a)(9). Except as otherwise provided in paragraph (b)(2) of this A–6, distribution of such separate account allocated to an alternate payee pursuant to a QDRO must be made in accordance with section 401(a)(9). For example, in general, distribution of such account will satisfy section 401(a)(9)(A) if required minimum distributions from such account during the employee's lifetime begin not later than the employee's required beginning date and the required minimum distribution is determined in accordance with § 1.401(a)(9)–5 for each distribution calendar year (using an applicable distribution period determined under A–4 of § 1.401(a)(9)–5 for the employee in the distribution calendar year either using the Uniform Lifetime Table in A–2 of § 1.401(a)(9)–9 or using the joint life expectancy of the employee and a spousal alternate payee in the distribution calendar year if the spousal alternate payee is more than 10 years younger than the employee). The determination of whether distribution from such account after the death of the employee to the alternate payee will be made in accordance with section 401(a)(9)(B)(i) or section 401(a)(9)(B)(ii) or (iii) and (iv) will depend on whether distributions have begun as determined under A–6 of § 1.401(a)(9)–2 (which provides, in general, that distributions are not treated as having begun until the employee's required beginning date even though payments may actually have begun before that date). For example, if the alternate payee dies before the employee and distribution of the separate account allocated to the alternate payee pursuant to the QDRO is to be made to the alternate payee's beneficiary, such beneficiary may be treated as a designated beneficiary for purposes of determining the minimum distribution required from such account after the death of the employee if the beneficiary of the alternate payee is an individual and if such beneficiary is a beneficiary under the plan or specified to or in the plan. Specification in or pursuant to the QDRO is treated as specification to the plan.

(2) Distribution of the separate account allocated to an alternate payee pursuant to a QDRO will satisfy the requirements of section 401(a)(9)(A)(ii) if such account is to be distributed, beginning not later than the employee's required beginning date, over the life of the alternate payee (or over a period not extending beyond the life expectancy of the alternate payee). Also, if the plan permits the employee to elect whether distribution upon the death of the employee will be made in accordance with the 5-year rule in section 401(a)(9)(B)(ii) or the life expectancy rule in section 401(a)(9)(B)(iii) and (iv)

pursuant to A–4(c) of § 1.401(a)(9)–3, such election is to be made only by the alternate payee for purposes of distributing the separate account allocated to the alternate payee pursuant to the QDRO. If the alternate payee dies after distribution of the separate account allocated to the alternate payee pursuant to a QDRO has begun (determined under A–6 of § 1.401(a)(9)–2) but before the employee dies, distribution of the remaining portion of that portion of the benefit allocated to the alternate payee must be made in accordance with the rules in § 1.401(a)(9)–5 or 1.401(a)(9)–6T for distributions during the life of the employee. Only after the death of the employee is the amount of the required minimum distribution determined in accordance with the rules of section 401(a)(9)(B).

(c) If a QDRO does not provide that an employee's benefit is to be divided but provides that a portion of an employee's benefit (otherwise payable to the employee) is to be paid to an alternate payee, such portion will not be treated as a separate account (or segregated share) of the employee. Instead, such portion will be aggregated with any amount distributed to the employee and will be treated as having been distributed to the employee for purposes of determining whether section 401(a)(9) has been satisfied with respect to that employee.

Q–7. Will a plan fail to satisfy section 401(a)(9) merely because it fails to distribute an amount otherwise required to be distributed by section 401(a)(9) during the period in which the issue of whether a domestic relations order is a QDRO is being determined?

A–7. A plan will not fail to satisfy section 401(a)(9) merely because it fails to distribute an amount otherwise required to be distributed by section 401(a)(9) during the period in which the issue of whether a domestic relations order is a QDRO is being determined pursuant to section 414(p)(7), provided that the period does not extend beyond the 18-month period described in section 414(p)(7)(E). To the extent that a distribution otherwise required under section 401(a)(9) is not made during this period, any segregated amounts, as defined in section 414(p)(7)(A), will be treated as though the amounts are not vested during the period and any distributions with respect to such amounts must be made under the relevant rules for nonvested benefits described in either A–8 of § 1.401(a)(9)–5 or A–6 of § 1.401(a)(9)–6T, as applicable.

Q–8. Will a plan fail to satisfy section 401(a)(9) where an individual's distribution from the plan is less than the amount otherwise required to satisfy section 401(a)(9) because distributions were being paid under an annuity contract issued by a life insurance company in state insurer delinquency proceedings and have been reduced or suspended by reasons of such state proceedings?

A–8. A plan will not fail to satisfy section 401(a)(9) merely because an individual's distribution from the plan is less than the amount otherwise required to satisfy section 401(a)(9) because distributions were being paid under an annuity contract issued by a life insurance company in state insurer delinquency proceedings and have been reduced or suspended by reasons of such state proceedings. To the extent that a distribution otherwise required under section 401(a)(9) is not made during the state insurer delinquency proceedings, this amount and any additional amount accrued during this period will be treated as though such amounts are not vested during the period and any distributions with respect to such amounts must be made under the relevant rules for nonvested benefits described in either A–8 of § 1.401(a)(9)–5 or A–6 of § 1.401(a)(9)–6T, as applicable.

Q–9. Will a plan fail to qualify as a pension plan within the meaning of section 401(a) solely because the plan permits distributions to commence to an employee on or after April 1 of the calendar year following the calendar year in which the employee attains age 70½ even though the employee has not retired or attained the normal retirement age under the plan as of the date on which such distributions commence?

A–9. No, a plan will not fail to qualify as a pension plan within the meaning of section 401(a) solely because the plan permits distributions to commence to an employee on or after April 1 of the calendar year following the calendar year in which the employee attains age 70½ even though the employee has not retired or attained the normal retirement age under the plan as of the date on which such distributions commence. This rule applies without regard to whether the employee is a 5-percent owner with respect to the plan year ending in the calendar year in which distributions commence.

Q–10. Is the distribution of an annuity contract a distribution for purposes of section 401(a)(9)?

A–10. No, the distribution of an annuity contract is not a distribution for purposes of section 401(a)(9).

Q–11. Will a payment by a plan after the death of an employee fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust?

A–11. A payment by a plan after the death of an employee will not fail to be treated as a distribution for purposes of section 401(a)(9) solely because it is made to an estate or a trust. As a result, the estate or trust which receives a payment from a plan after the death of an employee need not distribute the amount of such payment to the beneficiaries of the estate or trust in accordance with section 401(a)(9)(B). Pursuant to A–3 of § 1.401(a)(9)–4, an estate may not be a designated beneficiary. Thus, pursuant to A–4 of § 1.401(a)(9)–3, distribution to the estate must satisfy the 5-year rule in section 401(a)(9)(B)(iii) if the distribution to the employee had not begun (as defined in A–6 of § 1.401(a)(9)–2) as of the employee's date of death. However, see A–5 and A–6 of § 1.401(a)(9)–4 for provisions under which beneficiaries of a trust with respect to the trust's interest in an employee's benefit are treated as having been designated as beneficiaries of the employee under the plan.

Q–12. Will a plan fail to satisfy section 411(d)(6) if the plan is amended to eliminate the availability of an optional form of benefit to the extent that the optional form does not satisfy section 401(a)(9)?

A–12. No, pursuant to section 411(d)(6)(B), a plan will not fail to satisfy section 411(d)(6) merely because the plan is amended to eliminate the availability of an optional form of benefit to the extent that the optional form does not satisfy section 401(a)(9). (See also A–3 of § 1.401(a)(9)–1, which requires a plan to

provide that, notwithstanding any other plan provision, it will not distribute benefits under any option that does not satisfy section 401(a)(9).)

Q–13. Is a plan disqualified merely because it pays benefits under a designation made before January 1, 1984, in accordance with section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act (TEFRA)?

A–13. No, even though the distribution requirements added by TEFRA were retroactively repealed by the Tax Reform Act of 1984 (TRA of 1984), the transitional election rule in section 242(b) of TEFRA was preserved. Satisfaction of the spousal consent requirements of section 417(a) and (e) (added by the Retirement Equity Act of 1984) will not be considered a revocation of the pre-1984 designation. However, sections 401(a)(11) and 417 must be satisfied with respect to any distribution subject to those sections. The election provided in section 242(b) of TEFRA is hereafter referred to as a section 242(b)(2) election.

Q–14. If an amount is transferred from one plan (transferor plan) to another plan (transferee plan), may the transferee plan distribute the amount transferred in accordance with a section 242(b)(2) election made under either the transferor plan or under the transferee plan?

A–14. (a) If an amount is transferred from one plan (transferor plan) to another plan (transferee plan), the amount transferred may be distributed in accordance with a section 242(b)(2) election made under the transferor plan if the employee did not elect to have the amount transferred and if the amount transferred is separately accounted for by the transferee plan. However, only the benefit attributable to the amount transferred, plus earnings thereon, may be distributed in accordance with the section 242(b)(2) election made under the transferor plan. If the employee elected to have the amount transferred, the transfer will be treated as a distribution and rollover of the amount transferred for purposes of this section.

(b) In the case in which an amount is transferred from one plan to another plan, the amount transferred may not be distributed in accordance with a section 242(b)(2) election made under the transferee plan. If a section 242(b)(2) election was made under the transferee plan, the amount transferred must be separately accounted for. If the amount transferred is not separately accounted for under the transferee plan, the section 242(b)(2) election under the transferee plan is revoked and section 401(a)(9) will apply to subsequent distributions by the transferee plan.

(c) A merger, spinoff, or consolidation, as defined in § 1.414(l)–1(b), will be treated as a transfer for purposes of the section 242(b)(2) election.

Q–15. If an amount is distributed by one plan (distributing plan) and rolled over into another plan (receiving plan), may the receiving plan distribute the amount rolled over in accordance with a section 242(b)(2) election made under either the distributing plan or the receiving plan?

A–15. No, if an amount is distributed by one plan (distributing plan) and rolled over into another plan (receiving plan), the receiving plan must distribute the amount rolled over in accordance with section 401(a)(9) whether or not the employee made a section 242(b)(2) election under the distributing plan. Further, if the amount rolled over was not distributed in accordance with the election, the election under the distributing plan is revoked and section 401(a)(9) will apply to all subsequent distributions by the distributing plan. Finally, if the employee made a section 242(b)(2) election under the receiving plan and such election is still in effect, the amount rolled over must be separately accounted for under the receiving plan and distributed in accordance with section 401(a)(9). If amounts rolled over are not separately accounted for, any section 242(b)(2) election under the receiving plan is revoked and section 401(a)(9) will apply to subsequent distributions by the receiving plan.

Q–16. May a section 242(b)(2) election be revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations?

A–16. Yes, a section 242(b)(2) election may be revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations. However, if the section 242(b)(2) election is revoked after the date by which distributions are required to commence in order to satisfy section 401(a)(9) and this section of the regulations and the total amount of the distributions which would have been required to be made prior to the date of the revocation in order to satisfy section 401(a)(9), but for the section 242(b)(2) election, have not been made, the plan must distribute by the end of the calendar year following the calendar year in which the revocation occurs the total amount not yet distributed which was required to have been distributed to satisfy the requirements of section 401(a)(9) and continue distributions in accordance with such requirements.

§ 1.401(a)(9)–9 Life expectancy and distribution period tables.

Q–1. What is the life expectancy for an individual for purposes of determining required minimum distributions under section 401(a)(9)?

A–1 The following table, referred to as the Single Life Table, is used for determining the life expectancy of an individual:

Single Life Table

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	82.4	**29**	54.3	**58**	27.0	**87**	6.7
1	81.6	**30**	53.3	**59**	26.1	**88**	6.3
2	80.6	**31**	52.4	**60**	25.2	**89**	5.9
3	79.7	**32**	51.4	**61**	24.4	**90**	5.5
4	78.7	**33**	50.4	**62**	23.5	**91**	5.2
5	77.7	**34**	49.4	**63**	22.7	**92**	4.9
6	76.7	**35**	48.5	**64**	21.8	**93**	4.6
7	75.8	**36**	47.5	**65**	21.0	**94**	4.3
8	74.8	**37**	46.5	**66**	20.2	**95**	4.1
9	73.8	**38**	45.6	**67**	19.4	**96**	3.8
10	72.8	**39**	44.6	**68**	18.6	**97**	3.6
11	71.8	**40**	43.6	**69**	17.8	**98**	3.4
12	70.8	**41**	42.7	**70**	17.0	**99**	3.1
13	69.9	**42**	41.7	**71**	16.3	**100**	2.9
14	68.9	**43**	40.7	**72**	15.5	**101**	2.7
15	67.9	**44**	39.8	**73**	14.8	**102**	2.5
16	66.9	**45**	38.8	**74**	14.1	**103**	2.3
17	66.0	**46**	37.9	**75**	13.4	**104**	2.1
18	65.0	**47**	37.0	**76**	12.7	**105**	1.9
19	64.0	**48**	36.0	**77**	12.1	**106**	1.7
20	63.0	**49**	35.1	**78**	11.4	**107**	1.5
21	62.1	**50**	34.2	**79**	10.8	**108**	1.4
22	61.1	**51**	33.3	**80**	10.2	**109**	1.2
23	60.1	**52**	32.3	**81**	9.7	**110**	1.1
24	59.1	**53**	31.4	**82**	9.1	**111+**	1.0
25	58.2	**54**	30.5	**83**	8.6		
26	57.2	**55**	29.6	**84**	8.1		
27	56.2	**56**	28.7	**85**	7.6		
28	55.3	**57**	27.9	**86**	7.1		

Q–2. What is the applicable distribution period for an individual account for purposes of determining required minimum distributions during an employee's lifetime under section 401(a)(9)?

A–2. *Table for determining distribution period.* The following table, referred to as the Uniform Lifetime Table, is used for determining the distribution period for lifetime distributions to an employee in situations in which the employee's spouse is either not the sole designated beneficiary or is the sole designated beneficiary but is not more than 10 years younger than the employee.

Uniform Lifetime Table

Age of employee	Distribution period	Age of employee	Distribution period
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115+	1.9

Q–3. What is the joint life and last survivor expectancy of an individual and beneficiary for purposes of determining required minimum distributions under section 401(a)(9)?

A–3. The following table, referred to as the Joint and Last Survivor Table, is used for determining the joint and last survivor life expectancy of two individuals:

Joint and Last Survivor Table

AGES	0	1	2	3	4	5	6	7	8	9
0	90.0	89.5	89.0	88.6	88.2	87.8	87.4	87.1	86.8	86.5
1	89.5	89.0	88.5	88.1	87.6	87.2	86.8	86.5	86.1	85.8
2	89.0	88.5	88.0	87.5	87.1	86.6	86.2	85.8	85.5	85.1
3	88.6	88.1	87.5	87.0	86.5	86.1	85.6	85.2	84.8	84.5
4	88.2	87.6	87.1	86.5	86.0	85.5	85.1	84.6	84.2	83.8
5	87.8	87.2	86.6	86.1	85.5	85.0	84.5	84.1	83.6	83.2
6	87.4	86.8	86.2	85.6	85.1	84.5	84.0	83.5	83.1	82.6
7	87.1	86.5	85.8	85.2	84.6	84.1	83.5	83.0	82.5	82.1
8	86.8	86.1	85.5	84.8	84.2	83.6	83.1	82.5	82.0	81.6
9	86.5	85.8	85.1	84.5	83.8	83.2	82.6	82.1	81.6	81.0
10	86.2	85.5	84.8	84.1	83.5	82.8	82.2	81.6	81.1	80.6
11	85.9	85.2	84.5	83.8	83.1	82.5	81.8	81.2	80.7	80.1
12	85.7	84.9	84.2	83.5	82.8	82.1	81.5	80.8	80.2	79.7
13	85.4	84.7	84.0	83.2	82.5	81.8	81.1	80.5	79.9	79.2
14	85.2	84.5	83.7	83.0	82.2	81.5	80.8	80.1	79.5	78.9
15	85.0	84.3	83.5	82.7	82.0	81.2	80.5	79.8	79.1	78.5
16	84.9	84.1	83.3	82.5	81.7	81.0	80.2	79.5	78.8	78.1
17	84.7	83.9	83.1	82.3	81.5	80.7	80.0	79.2	78.5	77.8
18	84.5	83.7	82.9	82.1	81.3	80.5	79.7	79.0	78.2	77.5
19	84.4	83.6	82.7	81.9	81.1	80.3	79.5	78.7	78.0	77.3

Joint and Last Survivor Table

AGES	0	1	2	3	4	5	6	7	8	9
20	84.3	83.4	82.6	81.8	80.9	80.1	79.3	78.5	77.7	77.0
21	84.1	83.3	82.4	81.6	80.8	79.9	79.1	78.3	77.5	76.8
22	84.0	83.2	82.3	81.5	80.6	79.8	78.9	78.1	77.3	76.5
23	83.9	83.1	82.2	81.3	80.5	79.6	78.8	77.9	77.1	76.3
24	83.8	83.0	82.1	81.2	80.3	79.5	78.6	77.8	76.9	76.1
25	83.7	82.9	82.0	81.1	80.2	79.3	78.5	77.6	76.8	75.9
26	83.6	82.8	81.9	81.0	80.1	79.2	78.3	77.5	76.6	75.8
27	83.6	82.7	81.8	80.9	80.0	79.1	78.2	77.4	76.5	75.6
28	83.5	82.6	81.7	80.8	79.9	79.0	78.1	77.2	76.4	75.5
29	83.4	82.6	81.6	80.7	79.8	78.9	78.0	77.1	76.2	75.4
30	83.4	82.5	81.6	80.7	79.7	78.8	77.9	77.0	76.1	75.2
31	83.3	82.4	81.5	80.6	79.7	78.8	77.8	76.9	76.0	75.1
32	83.3	82.4	81.5	80.5	79.6	78.7	77.8	76.8	75.9	75.0
33	83.2	82.3	81.4	80.5	79.5	78.6	77.7	76.8	75.9	74.9
34	83.2	82.3	81.3	80.4	79.5	78.5	77.6	76.7	75.8	74.9
35	83.1	82.2	81.3	80.4	79.4	78.5	77.6	76.6	75.7	74.8
36	83.1	82.2	81.3	80.3	79.4	78.4	77.5	76.6	75.6	74.7
37	83.0	82.2	81.2	80.3	79.3	78.4	77.4	76.5	75.6	74.6
38	83.0	82.1	81.2	80.2	79.3	78.3	77.4	76.4	75.5	74.6
39	83.0	82.1	81.1	80.2	79.2	78.3	77.3	76.4	75.5	74.5
40	82.9	82.1	81.1	80.2	79.2	78.3	77.3	76.4	75.4	74.5
41	82.9	82.0	81.1	80.1	79.2	78.2	77.3	76.3	75.4	74.4
42	82.9	82.0	81.1	80.1	79.1	78.2	77.2	76.3	75.3	74.4
43	82.9	82.0	81.0	80.1	79.1	78.2	77.2	76.2	75.3	74.3
44	82.8	81.9	81.0	80.0	79.1	78.1	77.2	76.2	75.2	74.3
45	82.8	81.9	81.0	80.0	79.1	78.1	77.1	76.2	75.2	74.3
46	82.8	81.9	81.0	80.0	79.0	78.1	77.1	76.1	75.2	74.2
47	82.8	81.9	80.9	80.0	79.0	78.0	77.1	76.1	75.2	74.2
48	82.8	81.9	80.9	80.0	79.0	78.0	77.1	76.1	75.1	74.2
49	82.7	81.8	80.9	79.9	79.0	78.0	77.0	76.1	75.1	74.1
50	82.7	81.8	80.9	79.9	79.0	78.0	77.0	76.0	75.1	74.1
51	82.7	81.8	80.9	79.9	78.9	78.0	77.0	76.0	75.1	74.1
52	82.7	81.8	80.9	79.9	78.9	78.0	77.0	76.0	75.0	74.1
53	82.7	81.8	80.8	79.9	78.9	77.9	77.0	76.0	75.0	74.0
54	82.7	81.8	80.8	79.9	78.9	77.9	76.9	76.0	75.0	74.0
55	82.6	81.8	80.8	79.8	78.9	77.9	76.9	76.0	75.0	74.0
56	82.6	81.7	80.8	79.8	78.9	77.9	76.9	75.9	75.0	74.0
57	82.6	81.7	80.8	79.8	78.9	77.9	76.9	75.9	75.0	74.0
58	82.6	81.7	80.8	79.8	78.8	77.9	76.9	75.9	74.9	74.0
59	82.6	81.7	80.8	79.8	78.8	77.9	76.9	75.9	74.9	74.0
60	82.6	81.7	80.8	79.8	78.8	77.8	76.9	75.9	74.9	73.9
61	82.6	81.7	80.8	79.8	78.8	77.8	76.9	75.9	74.9	73.9
62	82.6	81.7	80.7	79.8	78.8	77.8	76.9	75.9	74.9	73.9
63	82.6	81.7	80.7	79.8	78.8	77.8	76.8	75.9	74.9	73.9
64	82.5	81.7	80.7	79.8	78.8	77.8	76.8	75.9	74.9	73.9
65	82.5	81.7	80.7	79.8	78.8	77.8	76.8	75.8	74.9	73.9
66	82.5	81.7	80.7	79.7	78.8	77.8	76.8	75.8	74.9	73.9
67	82.5	81.7	80.7	79.7	78.8	77.8	76.8	75.8	74.9	73.9
68	82.5	81.6	80.7	79.7	78.8	77.8	76.8	75.8	74.8	73.9
69	82.5	81.6	80.7	79.7	78.8	77.8	76.8	75.8	74.8	73.9

Joint and Last Survivor Table

AGES	0	1	2	3	4	5	6	7	8	9
70	82.5	81.6	80.7	79.7	78.8	77.8	76.8	75.8	74.8	73.9
71	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
72	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
73	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
74	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
75	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
76	82.5	81.6	80.7	79.7	78.7	77.8	76.8	75.8	74.8	73.8
77	82.5	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
78	82.5	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
79	82.5	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
80	82.5	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
81	82.4	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
82	82.4	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
83	82.4	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
84	82.4	81.6	80.7	79.7	78.7	77.7	76.8	75.8	74.8	73.8
85	82.4	81.6	80.6	79.7	78.7	77.7	76.8	75.8	74.8	73.8
86	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
87	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
88	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
89	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
90	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
91	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
92	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
93	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
94	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
95	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
96	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
97	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
98	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
99	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
100	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
101	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
102	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
103	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
104	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
105	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
106	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
107	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
108	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
109	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
110	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
111	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
112	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
113	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
114	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8
115+	82.4	81.6	80.6	79.7	78.7	77.7	76.7	75.8	74.8	73.8

AGES	10	11	12	13	14	15	16	17	18	19
10	80.0	79.6	79.1	78.7	78.2	77.9	77.5	77.2	76.8	76.5
11	79.6	79.0	78.6	78.1	77.7	77.3	76.9	76.5	76.2	75.8

Joint and Last Survivor Table

AGES	10	11	12	13	14	15	16	17	18	19
12	79.1	78.6	78.1	77.6	77.1	76.7	76.3	75.9	75.5	75.2
13	78.7	78.1	77.6	77.1	76.6	76.1	75.7	75.3	74.9	74.5
14	78.2	77.7	77.1	76.6	76.1	75.6	75.1	74.7	74.3	73.9
15	77.9	77.3	76.7	76.1	75.6	75.1	74.6	74.1	73.7	73.3
16	77.5	76.9	76.3	75.7	75.1	74.6	74.1	73.6	73.1	72.7
17	77.2	76.5	75.9	75.3	74.7	74.1	73.6	73.1	72.6	72.1
18	76.8	76.2	75.5	74.9	74.3	73.7	73.1	72.6	72.1	71.6
19	76.5	75.8	75.2	74.5	73.9	73.3	72.7	72.1	71.6	71.1
20	76.3	75.5	74.8	74.2	73.5	72.9	72.3	71.7	71.1	70.6
21	76.0	75.3	74.5	73.8	73.2	72.5	71.9	71.3	70.7	70.1
22	75.8	75.0	74.3	73.5	72.9	72.2	71.5	70.9	70.3	69.7
23	75.5	74.8	74.0	73.3	72.6	71.9	71.2	70.5	69.9	69.3
24	75.3	74.5	73.8	73.0	72.3	71.6	70.9	70.2	69.5	68.9
25	75.1	74.3	73.5	72.8	72.0	71.3	70.6	69.9	69.2	68.5
26	75.0	74.1	73.3	72.5	71.8	71.0	70.3	69.6	68.9	68.2
27	74.8	74.0	73.1	72.3	71.6	70.8	70.0	69.3	68.6	67.9
28	74.6	73.8	73.0	72.2	71.3	70.6	69.8	69.0	68.3	67.6
29	74.5	73.6	72.8	72.0	71.2	70.4	69.6	68.8	68.0	67.3
30	74.4	73.5	72.7	71.8	71.0	70.2	69.4	68.6	67.8	67.1
31	74.3	73.4	72.5	71.7	70.8	70.0	69.2	68.4	67.6	66.8
32	74.1	73.3	72.4	71.5	70.7	69.8	69.0	68.2	67.4	66.6
33	74.0	73.2	72.3	71.4	70.5	69.7	68.8	68.0	67.2	66.4
34	73.9	73.0	72.2	71.3	70.4	69.5	68.7	67.8	67.0	66.2
35	73.9	73.0	72.1	71.2	70.3	69.4	68.5	67.7	66.8	66.0
36	73.8	72.9	72.0	71.1	70.2	69.3	68.4	67.6	66.7	65.9
37	73.7	72.8	71.9	71.0	70.1	69.2	68.3	67.4	66.6	65.7
38	73.6	72.7	71.8	70.9	70.0	69.1	68.2	67.3	66.4	65.6
39	73.6	72.7	71.7	70.8	69.9	69.0	68.1	67.2	66.3	65.4
40	73.5	72.6	71.7	70.7	69.8	68.9	68.0	67.1	66.2	65.3
41	73.5	72.5	71.6	70.7	69.7	68.8	67.9	67.0	66.1	65.2
42	73.4	72.5	71.5	70.6	69.7	68.8	67.8	66.9	66.0	65.1
43	73.4	72.4	71.5	70.6	69.6	68.7	67.8	66.8	65.9	65.0
44	73.3	72.4	71.4	70.5	69.6	68.6	67.7	66.8	65.9	64.9
45	73.3	72.3	71.4	70.5	69.5	68.6	67.6	66.7	65.8	64.9
46	73.3	72.3	71.4	70.4	69.5	68.5	67.6	66.6	65.7	64.8
47	73.2	72.3	71.3	70.4	69.4	68.5	67.5	66.6	65.7	64.7
48	73.2	72.2	71.3	70.3	69.4	68.4	67.5	66.5	65.6	64.7
49	73.2	72.2	71.2	70.3	69.3	68.4	67.4	66.5	65.6	64.6
50	73.1	72.2	71.2	70.3	69.3	68.4	67.4	66.5	65.5	64.6
51	73.1	72.2	71.2	70.2	69.3	68.3	67.4	66.4	65.5	64.5
52	73.1	72.1	71.2	70.2	69.2	68.3	67.3	66.4	65.4	64.5
53	73.1	72.1	71.1	70.2	69.2	68.3	67.3	66.3	65.4	64.4
54	73.1	72.1	71.1	70.2	69.2	68.2	67.3	66.3	65.4	64.4
55	73.0	72.1	71.1	70.1	69.2	68.2	67.2	66.3	65.3	64.4
56	73.0	72.1	71.1	70.1	69.1	68.2	67.2	66.3	65.3	64.3
57	73.0	72.0	71.1	70.1	69.1	68.2	67.2	66.2	65.3	64.3
58	73.0	72.0	71.0	70.1	69.1	68.1	67.2	66.2	65.2	64.3
59	73.0	72.0	71.0	70.1	69.1	68.1	67.2	66.2	65.2	64.3

Joint and Last Survivor Table

AGES	10	11	12	13	14	15	16	17	18	19
60	73.0	72.0	71.0	70.0	69.1	68.1	67.1	66.2	65.2	64.2
61	73.0	72.0	71.0	70.0	69.1	68.1	67.1	66.2	65.2	64.2
62	72.9	72.0	71.0	70.0	69.0	68.1	67.1	66.1	65.2	64.2
63	72.9	72.0	71.0	70.0	69.0	68.1	67.1	66.1	65.2	64.2
64	72.9	71.9	71.0	70.0	69.0	68.0	67.1	66.1	65.1	64.2
65	72.9	71.9	71.0	70.0	69.0	68.0	67.1	66.1	65.1	64.2
66	72.9	71.9	70.9	70.0	69.0	68.0	67.1	66.1	65.1	64.1
67	72.9	71.9	70.9	70.0	69.0	68.0	67.0	66.1	65.1	64.1
68	72.9	71.9	70.9	70.0	69.0	68.0	67.0	66.1	65.1	64.1
69	72.9	71.9	70.9	69.9	69.0	68.0	67.0	66.1	65.1	64.1
70	72.9	71.9	70.9	69.9	69.0	68.0	67.0	66.0	65.1	64.1
71	72.9	71.9	70.9	69.9	69.0	68.0	67.0	66.0	65.1	64.1
72	72.9	71.9	70.9	69.9	69.0	68.0	67.0	66.0	65.1	64.1
73	72.9	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
74	72.9	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
75	72.8	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
76	72.8	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
77	72.8	71.9	70.9	69.9	68.9	68.0	67.0	66.0	65.0	64.1
78	72.8	71.9	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
79	72.8	71.9	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
80	72.8	71.9	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
81	72.8	71.8	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
82	72.8	71.8	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
83	72.8	71.8	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
84	72.8	71.8	70.9	69.9	68.9	67.9	67.0	66.0	65.0	64.0
85	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
86	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
87	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
88	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
89	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
90	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
91	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
92	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
93	72.8	71.8	70.9	69.9	68.9	67.9	66.9	66.0	65.0	64.0
94	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
95	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
96	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
97	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
98	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
99	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
100	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
101	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
102	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
103	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
104	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
105	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
106	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
107	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
108	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
109	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0

Joint and Last Survivor Table

AGES	10	11	12	13	14	15	16	17	18	19
110	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
111	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
112	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
113	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
114	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0
115+	72.8	71.8	70.8	69.9	68.9	67.9	66.9	66.0	65.0	64.0

AGES	20	21	22	23	24	25	26	27	28	29
20	70.1	69.6	69.1	68.7	68.3	67.9	67.5	67.2	66.9	66.6
21	69.6	69.1	68.6	68.2	67.7	67.3	66.9	66.6	66.2	65.9
22	69.1	68.6	68.1	67.6	67.2	66.7	66.3	65.9	65.6	65.2
23	68.7	68.2	67.6	67.1	66.6	66.2	65.7	65.3	64.9	64.6
24	68.3	67.7	67.2	66.6	66.1	65.6	65.2	64.7	64.3	63.9
25	67.9	67.3	66.7	66.2	65.6	65.1	64.6	64.2	63.7	63.3
26	67.5	66.9	66.3	65.7	65.2	64.6	64.1	63.6	63.2	62.8
27	67.2	66.6	65.9	65.3	64.7	64.2	63.6	63.1	62.7	62.2
28	66.9	66.2	65.6	64.9	64.3	63.7	63.2	62.7	62.1	61.7
29	66.6	65.9	65.2	64.6	63.9	63.3	62.8	62.2	61.7	61.2
30	66.3	65.6	64.9	64.2	63.6	62.9	62.3	61.8	61.2	60.7
31	66.1	65.3	64.6	63.9	63.2	62.6	62.0	61.4	60.8	60.2
32	65.8	65.1	64.3	63.6	62.9	62.2	61.6	61.0	60.4	59.8
33	65.6	64.8	64.1	63.3	62.6	61.9	61.3	60.6	60.0	59.4
34	65.4	64.6	63.8	63.1	62.3	61.6	60.9	60.3	59.6	59.0
35	65.2	64.4	63.6	62.8	62.1	61.4	60.6	59.9	59.3	58.6
36	65.0	64.2	63.4	62.6	61.9	61.1	60.4	59.6	59.0	58.3
37	64.9	64.0	63.2	62.4	61.6	60.9	60.1	59.4	58.7	58.0
38	64.7	63.9	63.0	62.2	61.4	60.6	59.9	59.1	58.4	57.7
39	64.6	63.7	62.9	62.1	61.2	60.4	59.6	58.9	58.1	57.4
40	64.4	63.6	62.7	61.9	61.1	60.2	59.4	58.7	57.9	57.1
41	64.3	63.5	62.6	61.7	60.9	60.1	59.3	58.5	57.7	56.9
42	64.2	63.3	62.5	61.6	60.8	59.9	59.1	58.3	57.5	56.7
43	64.1	63.2	62.4	61.5	60.6	59.8	58.9	58.1	57.3	56.5
44	64.0	63.1	62.2	61.4	60.5	59.6	58.8	57.9	57.1	56.3
45	64.0	63.0	62.2	61.3	60.4	59.5	58.6	57.8	56.9	56.1
46	63.9	63.0	62.1	61.2	60.3	59.4	58.5	57.7	56.8	56.0
47	63.8	62.9	62.0	61.1	60.2	59.3	58.4	57.5	56.7	55.8
48	63.7	62.8	61.9	61.0	60.1	59.2	58.3	57.4	56.5	55.7
49	63.7	62.8	61.8	60.9	60.0	59.1	58.2	57.3	56.4	55.6
50	63.6	62.7	61.8	60.8	59.9	59.0	58.1	57.2	56.3	55.4
51	63.6	62.6	61.7	60.8	59.9	58.9	58.0	57.1	56.2	55.3
52	63.5	62.6	61.7	60.7	59.8	58.9	58.0	57.1	56.1	55.2
53	63.5	62.5	61.6	60.7	59.7	58.8	57.9	57.0	56.1	55.2
54	63.5	62.5	61.6	60.6	59.7	58.8	57.8	56.9	56.0	55.1
55	63.4	62.5	61.5	60.6	59.6	58.7	57.8	56.8	55.9	55.0
56	63.4	62.4	61.5	60.5	59.6	58.7	57.7	56.8	55.9	54.9
57	63.4	62.4	61.5	60.5	59.6	58.6	57.7	56.7	55.8	54.9
58	63.3	62.4	61.4	60.5	59.5	58.6	57.6	56.7	55.8	54.8
59	63.3	62.3	61.4	60.4	59.5	58.5	57.6	56.7	55.7	54.8
60	63.3	62.3	61.4	60.4	59.5	58.5	57.6	56.6	55.7	54.7
61	63.3	62.3	61.3	60.4	59.4	58.5	57.5	56.6	55.6	54.7

Joint and Last Survivor Table

AGES	20	21	22	23	24	25	26	27	28	29
62	63.2	62.3	61.3	60.4	59.4	58.4	57.5	56.5	55.6	54.7
63	63.2	62.3	61.3	60.3	59.4	58.4	57.5	56.5	55.6	54.6
64	63.2	62.2	61.3	60.3	59.4	58.4	57.4	56.5	55.5	54.6
65	63.2	62.2	61.3	60.3	59.3	58.4	57.4	56.5	55.5	54.6
66	63.2	62.2	61.2	60.3	59.3	58.4	57.4	56.4	55.5	54.5
67	63.2	62.2	61.2	60.3	59.3	58.3	57.4	56.4	55.5	54.5
68	63.1	62.2	61.2	60.2	59.3	58.3	57.4	56.4	55.4	54.5
69	63.1	62.2	61.2	60.2	59.3	58.3	57.3	56.4	55.4	54.5
70	63.1	62.2	61.2	60.2	59.3	58.3	57.3	56.4	55.4	54.4
71	63.1	62.1	61.2	60.2	59.2	58.3	57.3	56.4	55.4	54.4
72	63.1	62.1	61.2	60.2	59.2	58.3	57.3	56.3	55.4	54.4
73	63.1	62.1	61.2	60.2	59.2	58.3	57.3	56.3	55.4	54.4
74	63.1	62.1	61.2	60.2	59.2	58.2	57.3	56.3	55.4	54.4
75	63.1	62.1	61.1	60.2	59.2	58.2	57.3	56.3	55.3	54.4
76	63.1	62.1	61.1	60.2	59.2	58.2	57.3	56.3	55.3	54.4
77	63.1	62.1	61.1	60.2	59.2	58.2	57.3	56.3	55.3	54.4
78	63.1	62.1	61.1	60.2	59.2	58.2	57.3	56.3	55.3	54.4
79	63.1	62.1	61.1	60.2	59.2	58.2	57.2	56.3	55.3	54.3
80	63.1	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
81	63.1	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
82	63.1	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
83	63.1	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
84	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
85	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.3	55.3	54.3
86	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.2	55.3	54.3
87	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.2	55.3	54.3
88	63.0	62.1	61.1	60.1	59.2	58.2	57.2	56.2	55.3	54.3
89	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
90	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
91	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
92	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
93	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
94	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
95	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
96	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
97	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
98	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
99	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
100	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
101	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
102	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
103	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
104	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
105	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
106	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
107	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
108	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
109	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
110	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
111	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3

Joint and Last Survivor Table

AGES	20	21	22	23	24	25	26	27	28	29
112	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
113	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
114	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3
115+	63.0	62.1	61.1	60.1	59.1	58.2	57.2	56.2	55.3	54.3

AGES	30	31	32	33	34	35	36	37	38	39
30	60.2	59.7	59.2	58.8	58.4	58.0	57.6	57.3	57.0	56.7
31	59.7	59.2	58.7	58.2	57.8	57.4	57.0	56.6	56.3	56.0
32	59.2	58.7	58.2	57.7	57.2	56.8	56.4	56.0	55.6	55.3
33	58.8	58.2	57.7	57.2	56.7	56.2	55.8	55.4	55.0	54.7
34	58.4	57.8	57.2	56.7	56.2	55.7	55.3	54.8	54.4	54.0
35	58.0	57.4	56.8	56.2	55.7	55.2	54.7	54.3	53.8	53.4
36	57.6	57.0	56.4	55.8	55.3	54.7	54.2	53.7	53.3	52.8
37	57.3	56.6	56.0	55.4	54.8	54.3	53.7	53.2	52.7	52.3
38	57.0	56.3	55.6	55.0	54.4	53.8	53.3	52.7	52.2	51.7
39	56.7	56.0	55.3	54.7	54.0	53.4	52.8	52.3	51.7	51.2
40	56.4	55.7	55.0	54.3	53.7	53.0	52.4	51.8	51.3	50.8
41	56.1	55.4	54.7	54.0	53.3	52.7	52.0	51.4	50.9	50.3
42	55.9	55.2	54.4	53.7	53.0	52.3	51.7	51.1	50.4	49.9
43	55.7	54.9	54.2	53.4	52.7	52.0	51.3	50.7	50.1	49.5
44	55.5	54.7	53.9	53.2	52.4	51.7	51.0	50.4	49.7	49.1
45	55.3	54.5	53.7	52.9	52.2	51.5	50.7	50.0	49.4	48.7
46	55.1	54.3	53.5	52.7	52.0	51.2	50.5	49.8	49.1	48.4
47	55.0	54.1	53.3	52.5	51.7	51.0	50.2	49.5	48.8	48.1
48	54.8	54.0	53.2	52.3	51.5	50.8	50.0	49.2	48.5	47.8
49	54.7	53.8	53.0	52.2	51.4	50.6	49.8	49.0	48.2	47.5
50	54.6	53.7	52.9	52.0	51.2	50.4	49.6	48.8	48.0	47.3
51	54.5	53.6	52.7	51.9	51.0	50.2	49.4	48.6	47.8	47.0
52	54.4	53.5	52.6	51.7	50.9	50.0	49.2	48.4	47.6	46.8
53	54.3	53.4	52.5	51.6	50.8	49.9	49.1	48.2	47.4	46.6
54	54.2	53.3	52.4	51.5	50.6	49.8	48.9	48.1	47.2	46.4
55	54.1	53.2	52.3	51.4	50.5	49.7	48.8	47.9	47.1	46.3
56	54.0	53.1	52.2	51.3	50.4	49.5	48.7	47.8	47.0	46.1
57	54.0	53.0	52.1	51.2	50.3	49.4	48.6	47.7	46.8	46.0
58	53.9	53.0	52.1	51.2	50.3	49.4	48.5	47.6	46.7	45.8
59	53.8	52.9	52.0	51.1	50.2	49.3	48.4	47.5	46.6	45.7
60	53.8	52.9	51.9	51.0	50.1	49.2	48.3	47.4	46.5	45.6
61	53.8	52.8	51.9	51.0	50.0	49.1	48.2	47.3	46.4	45.5
62	53.7	52.8	51.8	50.9	50.0	49.1	48.1	47.2	46.3	45.4
63	53.7	52.7	51.8	50.9	49.9	49.0	48.1	47.2	46.3	45.3
64	53.6	52.7	51.8	50.8	49.9	48.9	48.0	47.1	46.2	45.3
65	53.6	52.7	51.7	50.8	49.8	48.9	48.0	47.0	46.1	45.2
66	53.6	52.6	51.7	50.7	49.8	48.9	47.9	47.0	46.1	45.1
67	53.6	52.6	51.7	50.7	49.8	48.8	47.9	46.9	46.0	45.1
68	53.5	52.6	51.6	50.7	49.7	48.8	47.8	46.9	46.0	45.0
69	53.5	52.6	51.6	50.6	49.7	48.7	47.8	46.9	45.9	45.0
70	53.5	52.5	51.6	50.6	49.7	48.7	47.8	46.8	45.9	44.9
71	53.5	52.5	51.6	50.6	49.6	48.7	47.7	46.8	45.9	44.9
72	53.5	52.5	51.5	50.6	49.6	48.7	47.7	46.8	45.8	44.9
73	53.4	52.5	51.5	50.6	49.6	48.6	47.7	46.7	45.8	44.8

Joint and Last Survivor Table

AGES	30	31	32	33	34	35	36	37	38	39
74	53.4	52.5	51.5	50.5	49.6	48.6	47.7	46.7	45.8	44.8
75	53.4	52.5	51.5	50.5	49.6	48.6	47.7	46.7	45.7	44.8
76	53.4	52.4	51.5	50.5	49.6	48.6	47.6	46.7	45.7	44.8
77	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.7	45.7	44.8
78	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.6	45.7	44.7
79	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.6	45.7	44.7
80	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.7	44.7
81	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.7	44.7
82	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
83	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
84	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
85	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.7
86	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
87	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
88	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
89	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
90	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
91	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
92	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
93	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
94	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
95	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
96	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
97	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
98	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
99	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
100	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
101	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
102	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
103	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
104	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
105	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
106	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
107	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
108	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
109	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
110	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
111	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
112	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
113	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
114	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
115+	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6

AGES	40	41	42	43	44	45	46	47	48	49
40	50.2	49.8	49.3	48.9	48.5	48.1	47.7	47.4	47.1	46.8
41	49.8	49.3	48.8	48.3	47.9	47.5	47.1	46.7	46.4	46.1
42	49.3	48.8	48.3	47.8	47.3	46.9	46.5	46.1	45.8	45.4
43	48.9	48.3	47.8	47.3	46.8	46.3	45.9	45.5	45.1	44.8
44	48.5	47.9	47.3	46.8	46.3	45.8	45.4	44.9	44.5	44.2
45	48.1	47.5	46.9	46.3	45.8	45.3	44.8	44.4	44.0	43.6

Joint and Last Survivor Table

AGES	40	41	42	43	44	45	46	47	48	49
46	47.7	47.1	46.5	45.9	45.4	44.8	44.3	43.9	43.4	43.0
47	47.4	46.7	46.1	45.5	44.9	44.4	43.9	43.4	42.9	42.4
48	47.1	46.4	45.8	45.1	44.5	44.0	43.4	42.9	42.4	41.9
49	46.8	46.1	45.4	44.8	44.2	43.6	43.0	42.4	41.9	41.4
50	46.5	45.8	45.1	44.4	43.8	43.2	42.6	42.0	41.5	40.9
51	46.3	45.5	44.8	44.1	43.5	42.8	42.2	41.6	41.0	40.5
52	46.0	45.3	44.6	43.8	43.2	42.5	41.8	41.2	40.6	40.1
53	45.8	45.1	44.3	43.6	42.9	42.2	41.5	40.9	40.3	39.7
54	45.6	44.8	44.1	43.3	42.6	41.9	41.2	40.5	39.9	39.3
55	45.5	44.7	43.9	43.1	42.4	41.6	40.9	40.2	39.6	38.9
56	45.3	44.5	43.7	42.9	42.1	41.4	40.7	40.0	39.3	38.6
57	45.1	44.3	43.5	42.7	41.9	41.2	40.4	39.7	39.0	38.3
58	45.0	44.2	43.3	42.5	41.7	40.9	40.2	39.4	38.7	38.0
59	44.9	44.0	43.2	42.4	41.5	40.7	40.0	39.2	38.5	37.8
60	44.7	43.9	43.0	42.2	41.4	40.6	39.8	39.0	38.2	37.5
61	44.6	43.8	42.9	42.1	41.2	40.4	39.6	38.8	38.0	37.3
62	44.5	43.7	42.8	41.9	41.1	40.3	39.4	38.6	37.8	37.1
63	44.5	43.6	42.7	41.8	41.0	40.1	39.3	38.5	37.7	36.9
64	44.4	43.5	42.6	41.7	40.8	40.0	39.2	38.3	37.5	36.7
65	44.3	43.4	42.5	41.6	40.7	39.9	39.0	38.2	37.4	36.6
66	44.2	43.3	42.4	41.5	40.6	39.8	38.9	38.1	37.2	36.4
67	44.2	43.3	42.3	41.4	40.6	39.7	38.8	38.0	37.1	36.3
68	44.1	43.2	42.3	41.4	40.5	39.6	38.7	37.9	37.0	36.2
69	44.1	43.1	42.2	41.3	40.4	39.5	38.6	37.8	36.9	36.0
70	44.0	43.1	42.2	41.3	40.3	39.4	38.6	37.7	36.8	35.9
71	44.0	43.0	42.1	41.2	40.3	39.4	38.5	37.6	36.7	35.9
72	43.9	43.0	42.1	41.1	40.2	39.3	38.4	37.5	36.6	35.8
73	43.9	43.0	42.0	41.1	40.2	39.3	38.4	37.5	36.6	35.7
74	43.9	42.9	42.0	41.1	40.1	39.2	38.3	37.4	36.5	35.6
75	43.8	42.9	42.0	41.0	40.1	39.2	38.3	37.4	36.5	35.6
76	43.8	42.9	41.9	41.0	40.1	39.1	38.2	37.3	36.4	35.5
77	43.8	42.9	41.9	41.0	40.0	39.1	38.2	37.3	36.4	35.5
78	43.8	42.8	41.9	40.9	40.0	39.1	38.2	37.2	36.3	35.4
79	43.8	42.8	41.9	40.9	40.0	39.1	38.1	37.2	36.3	35.4
80	43.7	42.8	41.8	40.9	40.0	39.0	38.1	37.2	36.3	35.4
81	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.2	36.2	35.3
82	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.1	36.2	35.3
83	43.7	42.8	41.8	40.9	39.9	39.0	38.0	37.1	36.2	35.3
84	43.7	42.7	41.8	40.8	39.9	39.0	38.0	37.1	36.2	35.3
85	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.2	35.2
86	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.1	35.2
87	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.0	36.1	35.2
88	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.0	36.1	35.2
89	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2
90	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2
91	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.2
92	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
93	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
94	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
95	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1

Joint and Last Survivor Table

AGES	40	41	42	43	44	45	46	47	48	49
96	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
97	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
98	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
99	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
100	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
101	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
102	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
103	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
104	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
105	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
106	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
107	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
108	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
109	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
110	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
111	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
112	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
113	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
114	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
115+	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1

AGES	50	51	52	53	54	55	56	57	58	59
50	40.4	40.0	39.5	39.1	38.7	38.3	38.0	37.6	37.3	37.1
51	40.0	39.5	39.0	38.5	38.1	37.7	37.4	37.0	36.7	36.4
52	39.5	39.0	38.5	38.0	37.6	37.2	36.8	36.4	36.0	35.7
53	39.1	38.5	38.0	37.5	37.1	36.6	36.2	35.8	35.4	35.1
54	38.7	38.1	37.6	37.1	36.6	36.1	35.7	35.2	34.8	34.5
55	38.3	37.7	37.2	36.6	36.1	35.6	35.1	34.7	34.3	33.9
56	38.0	37.4	36.8	36.2	35.7	35.1	34.7	34.2	33.7	33.3
57	37.6	37.0	36.4	35.8	35.2	34.7	34.2	33.7	33.2	32.8
58	37.3	36.7	36.0	35.4	34.8	34.3	33.7	33.2	32.8	32.3
59	37.1	36.4	35.7	35.1	34.5	33.9	33.3	32.8	32.3	31.8
60	36.8	36.1	35.4	34.8	34.1	33.5	32.9	32.4	31.9	31.3
61	36.6	35.8	35.1	34.5	33.8	33.2	32.6	32.0	31.4	30.9
62	36.3	35.6	34.9	34.2	33.5	32.9	32.2	31.6	31.1	30.5
63	36.1	35.4	34.6	33.9	33.2	32.6	31.9	31.3	30.7	30.1
64	35.9	35.2	34.4	33.7	33.0	32.3	31.6	31.0	30.4	29.8
65	35.8	35.0	34.2	33.5	32.7	32.0	31.4	30.7	30.0	29.4
66	35.6	34.8	34.0	33.3	32.5	31.8	31.1	30.4	29.8	29.1
67	35.5	34.7	33.9	33.1	32.3	31.6	30.9	30.2	29.5	28.8
68	35.3	34.5	33.7	32.9	32.1	31.4	30.7	29.9	29.2	28.6
69	35.2	34.4	33.6	32.8	32.0	31.2	30.5	29.7	29.0	28.3
70	35.1	34.3	33.4	32.6	31.8	31.1	30.3	29.5	28.8	28.1
71	35.0	34.2	33.3	32.5	31.7	30.9	30.1	29.4	28.6	27.9
72	34.9	34.1	33.2	32.4	31.6	30.8	30.0	29.2	28.4	27.7
73	34.8	34.0	33.1	32.3	31.5	30.6	29.8	29.1	28.3	27.5
74	34.8	33.9	33.0	32.2	31.4	30.5	29.7	28.9	28.1	27.4
75	34.7	33.8	33.0	32.1	31.3	30.4	29.6	28.8	28.0	27.2
76	34.6	33.8	32.9	32.0	31.2	30.3	29.5	28.7	27.9	27.1
77	34.6	33.7	32.8	32.0	31.1	30.3	29.4	28.6	27.8	27.0

Joint and Last Survivor Table

AGES	50	51	52	53	54	55	56	57	58	59
78	34.5	33.6	32.8	31.9	31.0	30.2	29.3	28.5	27.7	26.9
79	34.5	33.6	32.7	31.8	31.0	30.1	29.3	28.4	27.6	26.8
80	34.5	33.6	32.7	31.8	30.9	30.1	29.2	28.4	27.5	26.7
81	34.4	33.5	32.6	31.8	30.9	30.0	29.2	28.3	27.5	26.6
82	34.4	33.5	32.6	31.7	30.8	30.0	29.1	28.3	27.4	26.6
83	34.4	33.5	32.6	31.7	30.8	29.9	29.1	28.2	27.4	26.5
84	34.3	33.4	32.5	31.7	30.8	29.9	29.0	28.2	27.3	26.5
85	34.3	33.4	32.5	31.6	30.7	29.9	29.0	28.1	27.3	26.4
86	34.3	33.4	32.5	31.6	30.7	29.8	29.0	28.1	27.2	26.4
87	34.3	33.4	32.5	31.6	30.7	29.8	28.9	28.1	27.2	26.4
88	34.3	33.4	32.5	31.6	30.7	29.8	28.9	28.0	27.2	26.3
89	34.3	33.3	32.4	31.5	30.7	29.8	28.9	28.0	27.2	26.3
90	34.2	33.3	32.4	31.5	30.6	29.8	28.9	28.0	27.1	26.3
91	34.2	33.3	32.4	31.5	30.6	29.7	28.9	28.0	27.1	26.3
92	34.2	33.3	32.4	31.5	30.6	29.7	28.8	28.0	27.1	26.2
93	34.2	33.3	32.4	31.5	30.6	29.7	28.8	28.0	27.1	26.2
94	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.1	26.2
95	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.1	26.2
96	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
97	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
98	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
99	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
100	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.1
101	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.1
102	34.2	33.3	32.4	31.4	30.5	29.7	28.8	27.9	27.0	26.1
103	34.2	33.3	32.4	31.4	30.5	29.7	28.8	27.9	27.0	26.1
104	34.2	33.3	32.4	31.4	30.5	29.6	28.8	27.9	27.0	26.1
105	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
106	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
107	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
108	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
109	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
110	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
111	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
112	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
113	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
114	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
115+	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1

AGES	60	61	62	63	64	65	66	67	68	69
60	30.9	30.4	30.0	29.6	29.2	28.8	28.5	28.2	27.9	27.6
61	30.4	29.9	29.5	29.0	28.6	28.3	27.9	27.6	27.3	27.0
62	30.0	29.5	29.0	28.5	28.1	27.7	27.3	27.0	26.7	26.4
63	29.6	29.0	28.5	28.1	27.6	27.2	26.8	26.4	26.1	25.7
64	29.2	28.6	28.1	27.6	27.1	26.7	26.3	25.9	25.5	25.2

Joint and Last Survivor Table

AGES	60	61	62	63	64	65	66	67	68	69
65	28.8	28.3	27.7	27.2	26.7	26.2	25.8	25.4	25.0	24.6
66	28.5	27.9	27.3	26.8	26.3	25.8	25.3	24.9	24.5	24.1
67	28.2	27.6	27.0	26.4	25.9	25.4	24.9	24.4	24.0	23.6
68	27.9	27.3	26.7	26.1	25.5	25.0	24.5	24.0	23.5	23.1
69	27.6	27.0	26.4	25.7	25.2	24.6	24.1	23.6	23.1	22.6
70	27.4	26.7	26.1	25.4	24.8	24.3	23.7	23.2	22.7	22.2
71	27.2	26.5	25.8	25.2	24.5	23.9	23.4	22.8	22.3	21.8
72	27.0	26.3	25.6	24.9	24.3	23.7	23.1	22.5	22.0	21.4
73	26.8	26.1	25.4	24.7	24.0	23.4	22.8	22.2	21.6	21.1
74	26.6	25.9	25.2	24.5	23.8	23.1	22.5	21.9	21.3	20.8
75	26.5	25.7	25.0	24.3	23.6	22.9	22.3	21.6	21.0	20.5
76	26.3	25.6	24.8	24.1	23.4	22.7	22.0	21.4	20.8	20.2
77	26.2	25.4	24.7	23.9	23.2	22.5	21.8	21.2	20.6	19.9
78	26.1	25.3	24.6	23.8	23.1	22.4	21.7	21.0	20.3	19.7
79	26.0	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.5
80	25.9	25.1	24.3	23.6	22.8	22.1	21.3	20.6	20.0	19.3
81	25.8	25.0	24.2	23.4	22.7	21.9	21.2	20.5	19.8	19.1
82	25.8	24.9	24.1	23.4	22.6	21.8	21.1	20.4	19.7	19.0
83	25.7	24.9	24.1	23.3	22.5	21.7	21.0	20.2	19.5	18.8
84	25.6	24.8	24.0	23.2	22.4	21.6	20.9	20.1	19.4	18.7
85	25.6	24.8	23.9	23.1	22.3	21.6	20.8	20.1	19.3	18.6
86	25.5	24.7	23.9	23.1	22.3	21.5	20.7	20.0	19.2	18.5
87	25.5	24.7	23.8	23.0	22.2	21.4	20.7	19.9	19.2	18.4
88	25.5	24.6	23.8	23.0	22.2	21.4	20.6	19.8	19.1	18.3
89	25.4	24.6	23.8	22.9	22.1	21.3	20.5	19.8	19.0	18.3
90	25.4	24.6	23.7	22.9	22.1	21.3	20.5	19.7	19.0	18.2
91	25.4	24.5	23.7	22.9	22.1	21.3	20.5	19.7	18.9	18.2
92	25.4	24.5	23.7	22.9	22.0	21.2	20.4	19.6	18.9	18.1
93	25.4	24.5	23.7	22.8	22.0	21.2	20.4	19.6	18.8	18.1
94	25.3	24.5	23.6	22.8	22.0	21.2	20.4	19.6	18.8	18.0
95	25.3	24.5	23.6	22.8	22.0	21.1	20.3	19.6	18.8	18.0
96	25.3	24.5	23.6	22.8	21.9	21.1	20.3	19.5	18.8	18.0
97	25.3	24.5	23.6	22.8	21.9	21.1	20.3	19.5	18.7	18.0
98	25.3	24.4	23.6	22.8	21.9	21.1	20.3	19.5	18.7	17.9
99	25.3	24.4	23.6	22.7	21.9	21.1	20.3	19.5	18.7	17.9
100	25.3	24.4	23.6	22.7	21.9	21.1	20.3	19.5	18.7	17.9
101	25.3	24.4	23.6	22.7	21.9	21.1	20.2	19.4	18.7	17.9
102	25.3	24.4	23.6	22.7	21.9	21.1	20.2	19.4	18.6	17.9
103	25.3	24.4	23.6	22.7	21.9	21.0	20.2	19.4	18.6	17.9
104	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
105	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
106	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
107	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
108	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
109	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8

Joint and Last Survivor Table

AGES	60	61	62	63	64	65	66	67	68	69
110	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
111	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
112	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
113	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
114	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
115+	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8

AGES	70	71	72	73	74	75	76	77	78	79
70	21.8	21.3	20.9	20.6	20.2	19.9	19.6	19.4	19.1	18.9
71	21.3	20.9	20.5	20.1	19.7	19.4	19.1	18.8	18.5	18.3
72	20.9	20.5	20.0	19.6	19.3	18.9	18.6	18.3	18.0	17.7
73	20.6	20.1	19.6	19.2	18.8	18.4	18.1	17.8	17.5	17.2
74	20.2	19.7	19.3	18.8	18.4	18.0	17.6	17.3	17.0	16.7
75	19.9	19.4	18.9	18.4	18.0	17.6	17.2	16.8	16.5	16.2
76	19.6	19.1	18.6	18.1	17.6	17.2	16.8	16.4	16.0	15.7
77	19.4	18.8	18.3	17.8	17.3	16.8	16.4	16.0	15.6	15.3
78	19.1	18.5	18.0	17.5	17.0	16.5	16.0	15.6	15.2	14.9
79	18.9	18.3	17.7	17.2	16.7	16.2	15.7	15.3	14.9	14.5
80	18.7	18.1	17.5	16.9	16.4	15.9	15.4	15.0	14.5	14.1
81	18.5	17.9	17.3	16.7	16.2	15.6	15.1	14.7	14.2	13.8
82	18.3	17.7	17.1	16.5	15.9	15.4	14.9	14.4	13.9	13.5
83	18.2	17.5	16.9	16.3	15.7	15.2	14.7	14.2	13.7	13.2
84	18.0	17.4	16.7	16.1	15.5	15.0	14.4	13.9	13.4	13.0
85	17.9	17.3	16.6	16.0	15.4	14.8	14.3	13.7	13.2	12.8
86	17.8	17.1	16.5	15.8	15.2	14.6	14.1	13.5	13.0	12.5
87	17.7	17.0	16.4	15.7	15.1	14.5	13.9	13.4	12.9	12.4
88	17.6	16.9	16.3	15.6	15.0	14.4	13.8	13.2	12.7	12.2
89	17.6	16.9	16.2	15.5	14.9	14.3	13.7	13.1	12.6	12.0
90	17.5	16.8	16.1	15.4	14.8	14.2	13.6	13.0	12.4	11.9
91	17.4	16.7	16.0	15.4	14.7	14.1	13.5	12.9	12.3	11.8
92	17.4	16.7	16.0	15.3	14.6	14.0	13.4	12.8	12.2	11.7
93	17.3	16.6	15.9	15.2	14.6	13.9	13.3	12.7	12.1	11.6
94	17.3	16.6	15.9	15.2	14.5	13.9	13.2	12.6	12.0	11.5
95	17.3	16.5	15.8	15.1	14.5	13.8	13.2	12.6	12.0	11.4
96	17.2	16.5	15.8	15.1	14.4	13.8	13.1	12.5	11.9	11.3
97	17.2	16.5	15.8	15.1	14.4	13.7	13.1	12.5	11.9	11.3
98	17.2	16.4	15.7	15.0	14.3	13.7	13.0	12.4	11.8	11.2
99	17.2	16.4	15.7	15.0	14.3	13.6	13.0	12.4	11.8	11.2
100	17.1	16.4	15.7	15.0	14.3	13.6	12.9	12.3	11.7	11.1
101	17.1	16.4	15.6	14.9	14.2	13.6	12.9	12.3	11.7	11.1
102	17.1	16.4	15.6	14.9	14.2	13.5	12.9	12.2	11.6	11.0
103	17.1	16.3	15.6	14.9	14.2	13.5	12.9	12.2	11.6	11.0
104	17.1	16.3	15.6	14.9	14.2	13.5	12.8	12.2	11.6	11.0
105	17.1	16.3	15.6	14.9	14.2	13.5	12.8	12.2	11.5	10.9
106	17.1	16.3	15.6	14.8	14.1	13.5	12.8	12.2	11.5	10.9

Joint and Last Survivor Table

AGES	70	71	72	73	74	75	76	77	78	79
107	17.0	16.3	15.6	14.8	14.1	13.4	12.8	12.1	11.5	10.9
108	17.0	16.3	15.5	14.8	14.1	13.4	12.8	12.1	11.5	10.9
109	17.0	16.3	15.5	14.8	14.1	13.4	12.8	12.1	11.5	10.9
110	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.9
111	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.8
112	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.8
113	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8
114	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8
115+	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8

AGES	80	81	82	83	84	85	86	87	88	89
80	13.8	13.4	13.1	12.8	12.6	12.3	12.1	11.9	11.7	11.5
81	13.4	13.1	12.7	12.4	12.2	11.9	11.7	11.4	11.3	11.1
82	13.1	12.7	12.4	12.1	11.8	11.5	11.3	11.0	10.8	10.6
83	12.8	12.4	12.1	11.7	11.4	11.1	10.9	10.6	10.4	10.2
84	12.6	12.2	11.8	11.4	11.1	10.8	10.5	10.3	10.1	9.9
85	12.3	11.9	11.5	11.1	10.8	10.5	10.2	9.9	9.7	9.5
86	12.1	11.7	11.3	10.9	10.5	10.2	9.9	9.6	9.4	9.2
87	11.9	11.4	11.0	10.6	10.3	9.9	9.6	9.4	9.1	8.9
88	11.7	11.3	10.8	10.4	10.1	9.7	9.4	9.1	8.8	8.6
89	11.5	11.1	10.6	10.2	9.9	9.5	9.2	8.9	8.6	8.3
90	11.4	10.9	10.5	10.1	9.7	9.3	9.0	8.6	8.3	8.1
91	11.3	10.8	10.3	9.9	9.5	9.1	8.8	8.4	8.1	7.9
92	11.2	10.7	10.2	9.8	9.3	9.0	8.6	8.3	8.0	7.7
93	11.1	10.6	10.1	9.6	9.2	8.8	8.5	8.1	7.8	7.5
94	11.0	10.5	10.0	9.5	9.1	8.7	8.3	8.0	7.6	7.3
95	10.9	10.4	9.9	9.4	9.0	8.6	8.2	7.8	7.5	7.2
96	10.8	10.3	9.8	9.3	8.9	8.5	8.1	7.7	7.4	7.1
97	10.7	10.2	9.7	9.2	8.8	8.4	8.0	7.6	7.3	6.9
98	10.7	10.1	9.6	9.2	8.7	8.3	7.9	7.5	7.1	6.8
99	10.6	10.1	9.6	9.1	8.6	8.2	7.8	7.4	7.0	6.7
100	10.6	10.0	9.5	9.0	8.5	8.1	7.7	7.3	6.9	6.6
101	10.5	10.0	9.4	9.0	8.5	8.0	7.6	7.2	6.9	6.5
102	10.5	9.9	9.4	8.9	8.4	8.0	7.5	7.1	6.8	6.4
103	10.4	9.9	9.4	8.8	8.4	7.9	7.5	7.1	6.7	6.3
104	10.4	9.8	9.3	8.8	8.3	7.9	7.4	7.0	6.6	6.3
105	10.4	9.8	9.3	8.8	8.3	7.8	7.4	7.0	6.6	6.2
106	10.3	9.8	9.2	8.7	8.2	7.8	7.3	6.9	6.5	6.2
107	10.3	9.8	9.2	8.7	8.2	7.7	7.3	6.9	6.5	6.1
108	10.3	9.7	9.2	8.7	8.2	7.7	7.3	6.8	6.4	6.1
109	10.3	9.7	9.2	8.7	8.2	7.7	7.2	6.8	6.4	6.0
110	10.3	9.7	9.2	8.6	8.1	7.7	7.2	6.8	6.4	6.0
111	10.3	9.7	9.1	8.6	8.1	7.6	7.2	6.8	6.3	6.0
112	10.2	9.7	9.1	8.6	8.1	7.6	7.2	6.7	6.3	5.9
113	10.2	9.7	9.1	8.6	8.1	7.6	7.2	6.7	6.3	5.9

Joint and Last Survivor Table

AGES	80	81	82	83	84	85	86	87	88	89
114	10.2	9.7	9.1	8.6	8.1	7.6	7.1	6.7	6.3	5.9
115+	10.2	9.7	9.1	8.6	8.1	7.6	7.1	6.7	6.3	5.9

AGES	90	91	92	93	94	95	96	97	98	99
90	7.8	7.6	7.4	7.2	7.1	6.9	6.8	6.6	6.5	6.4
91	7.6	7.4	7.2	7.0	6.8	6.7	6.5	6.4	6.3	6.1
92	7.4	7.2	7.0	6.8	6.6	6.4	6.3	6.1	6.0	5.9
93	7.2	7.0	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.6
94	7.1	6.8	6.6	6.4	6.2	6.0	5.9	5.7	5.6	5.4
95	6.9	6.7	6.4	6.2	6.0	5.8	5.7	5.5	5.4	5.2
96	6.8	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.2	5.0
97	6.6	6.4	6.1	5.9	5.7	5.5	5.3	5.2	5.0	4.9
98	6.5	6.3	6.0	5.8	5.6	5.4	5.2	5.0	4.8	4.7
99	6.4	6.1	5.9	5.6	5.4	5.2	5.0	4.9	4.7	4.5
100	6.3	6.0	5.8	5.5	5.3	5.1	4.9	4.7	4.5	4.4
101	6.2	5.9	5.6	5.4	5.2	5.0	4.8	4.6	4.4	4.2
102	6.1	5.8	5.5	5.3	5.1	4.8	4.6	4.4	4.3	4.1
103	6.0	5.7	5.4	5.2	5.0	4.7	4.5	4.3	4.1	4.0
104	5.9	5.6	5.4	5.1	4.9	4.6	4.4	4.2	4.0	3.8
105	5.9	5.6	5.3	5.0	4.8	4.5	4.3	4.1	3.9	3.7
106	5.8	5.5	5.2	4.9	4.7	4.5	4.2	4.0	3.8	3.6
107	5.8	5.4	5.1	4.9	4.6	4.4	4.2	3.9	3.7	3.5
108	5.7	5.4	5.1	4.8	4.6	4.3	4.1	3.9	3.7	3.5
109	5.7	5.3	5.0	4.8	4.5	4.3	4.0	3.8	3.6	3.4
110	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.8	3.5	3.3
111	5.6	5.3	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3
112	5.6	5.3	4.9	4.7	4.4	4.1	3.9	3.7	3.5	3.2
113	5.6	5.2	4.9	4.6	4.4	4.1	3.9	3.6	3.4	3.2
114	5.6	5.2	4.9	4.6	4.3	4.1	3.9	3.6	3.4	3.2
115+	5.5	5.2	4.9	4.6	4.3	4.1	3.8	3.6	3.4	3.1

AGES	100	101	102	103	104	105	106	107	108	109
100	4.2	4.1	3.9	3.8	3.7	3.5	3.4	3.3	3.3	3.2
101	4.1	3.9	3.7	3.6	3.5	3.4	3.2	3.1	3.1	3.0
102	3.9	3.7	3.6	3.4	3.3	3.2	3.1	3.0	2.9	2.8
103	3.8	3.6	3.4	3.3	3.2	3.0	2.9	2.8	2.7	2.6
104	3.7	3.5	3.3	3.2	3.0	2.9	2.7	2.6	2.5	2.4
105	3.5	3.4	3.2	3.0	2.9	2.7	2.6	2.5	2.4	2.3
106	3.4	3.2	3.1	2.9	2.7	2.6	2.4	2.3	2.2	2.1
107	3.3	3.1	3.0	2.8	2.6	2.5	2.3	2.2	2.1	2.0
108	3.3	3.1	2.9	2.7	2.5	2.4	2.2	2.1	1.9	1.8
109	3.2	3.0	2.8	2.6	2.4	2.3	2.1	2.0	1.8	1.7
110	3.1	2.9	2.7	2.5	2.3	2.2	2.0	1.9	1.7	1.6
111	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.8	1.6	1.5
112	3.0	2.8	2.6	2.4	2.2	2.0	1.9	1.7	1.5	1.4
113	3.0	2.8	2.6	2.4	2.2	2.0	1.8	1.6	1.5	1.3

Joint and Last Survivor Table

AGES	100	101	102	103	104	105	106	107	108	109
114	3.0	2.7	2.5	2.3	2.1	1.9	1.8	1.6	1.4	1.3
115+	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.4	1.2

AGES	110	111	112	113	114	115+
110	1.5	1.4	1.3	1.2	1.1	1.1
111	1.4	1.2	1.1	1.1	1.0	1.0
112	1.3	1.1	1.0	1.0	1.0	1.0
113	1.2	1.1	1.0	1.0	1.0	1.0
114	1.1	1.0	1.0	1.0	1.0	1.0
115+	1.1	1.0	1.0	1.0	1.0	1.0

Q–4. May the tables under this section be changed?

A–4. The Single Life Table, Uniform Lifetime Table and Joint and Last Survivor Table provided in A–1 through A–3 of this section may be changed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(b) of this chapter.

Par. 3. Section 1.403(b)–3 is added to read as follows:

§ 1.403(b)–3 Required minimum distributions from annuity contracts purchased, or custodial accounts or retirement income accounts established, by a section 501(c)(3) organization or a public school.

Q–1. Are section 403(b) contracts subject to the distribution rules provided in section 401(a)(9)?

A–1. (a) Yes, section 403(b) contracts are subject to the distribution rules provided in section 401(a)(9). For purposes of this section, the term *section 403(b) contract* means an annuity contract described in section 403(b)(1), custodial account described in section 403(b)(7), or retirement income account described in section 403(b)(9).

(b) For purposes of applying the distribution rules in section 401(a)(9), section 403(b) contracts will be treated as individual retirement annuities described in section 408(b) and individual retirement accounts described in section 408(a) (IRAs). Consequently, except as otherwise provided in paragraph (c) of this A–1, the distribution rules in section 401(a)(9) will be applied to section 403(b) contracts in accordance with the provisions in § 1.408–8 for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2003.

(c)(1) The required beginning date for purposes of section 403(b)(10) is April 1 of the calendar year following the later of the calendar year in which the employee attains 70½ or the calendar year in which the employee retires from employment with the employer maintaining the plan. The concept of 5–percent owner has no application in the case of employees of employers described in section 403(b)(1)(A).

(2) The rule in A–5 of § 1.408–8 does not apply to section 403(b) contracts. Thus, the surviving spouse of an employee is not permitted to treat a section 403(b) contract of which the spouse is the sole beneficiary as the spouse's own section 403(b) contract.

(3) Annuity payments provided with respect to retirement income accounts described in section 403(b)(9) will not fail to satisfy the requirements of A–4 of § 1.401(a)(9)–6T merely because the payments are not made under an annuity contract purchased from an insurance company, provided the relationship between the annuity payments and the retirement income accounts is not inconsistent with any rules prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(b) of this chapter.

Q–2. To what benefits under section 403(b) contracts do the distribution rules provided in section 401(a)(9) apply?

A–2. (a) The distribution rules provided in section 401(a)(9) apply to all benefits under section 403(b) contracts accruing after December 31, 1986 (post-'86 account balance). The distribution rules provided in section 401(a)(9) do not apply to the undistributed portion of the account balance under the section 403(b) contract valued as of December 31, 1986, exclusive of subsequent earnings (pre-'87 account balance). Consequently, the post-'86 account balance includes earnings after December 31, 1986, on contributions made before January 1, 1987, in addition to the contributions made after December 31, 1986, and earnings thereon.

(b) The issuer or custodian of the section 403(b) contract must keep records that enable it to identify the pre-'87 account balance and subsequent changes as set forth in paragraph (b) of this A–2 and provide such information upon request to the relevant employee or beneficiaries with respect to the contract. If the issuer or custodian does not keep such records, the entire account balance will be treated as subject to section 401(a)(9).

(c) In applying the distribution rules in section 401(a)(9), only the post-'86 account balance is used to calculate the required minimum distribution for a calendar year. The amount of any distribution from a contract will be treated as being paid from the post-'86 account balance to the extent the distribution is required to satisfy the minimum distribution requirement with respect to that contract for a calendar year. Any amount distributed in a calendar year from a contract

in excess of the required minimum distribution for a calendar year with respect to that contract will be treated as paid from the pre-'87 account balance, if any, of that contract.

(d) If an amount is distributed from the pre-'87 account balance and rolled over to another section 403(b) contract, the amount will be treated as part of the post-'86 account balance in that second contract. However, if the pre-'87 account balance under a section 403(b) contract is directly transferred to another section 403(b) contract, the amount transferred retains its character as a pre-'87 account balance, provided the issuer of the transferee contract satisfies the recordkeeping requirements of paragraph (b) of this A–2.

(e) The distinction between the pre-'87 account balance and the post-'86 account balance provided for under this A–2 has no relevance for purposes of determining the portion of a distribution that is includible in income under section 72.

Q–3. Must the pre-'87 account balance be distributed in accordance with the incidental benefit requirement?

A–3. Yes, the pre-'87 account balance must be distributed in accordance with the incidental benefit requirement of § 1.401–1(b)(1)(i). Distributions attributable to the pre-'87 account balance are treated as satisfying this requirement if all distributions from the section 403(b) contract (including distributions attributable to the post-'86 account balance) satisfy the requirements of § 1.401–1(b)(1)(i) without regard to this section, and distributions attributable to the post-'86 account balance satisfy the rules of this section. Alternatively, distributions attributable to the pre-'87 account balance are treated as satisfying the incidental benefit requirement if all distributions from the section 403(b) contract (including distributions attributable to both the pre-'87 account balance and the post-'86 account balance) satisfy the rules of this section.

Q–4. Is the required minimum distribution from one section 403(b) contract of an employee permitted to be distributed from another section 403(b) contract in order to satisfy section 401(a)(9)?

A–4. Yes, as provided in paragraph (b) of A–1 of this section, the distribution rules in section 401(a)(9) will be applied to section 403(b) contracts in accordance with the provisions in § 1.408–8. Thus, the required minimum distribution must be separately determined for each section 403(b) contract of an employee. However, as provided in A–9 of § 1.408–8 with respect to IRAs, such amounts may then be totaled and the total distribution taken from any one or more of the individual section 403(b) contracts. However, consistent with the rules in A–9 of § 1.408–8, only amounts in section 403(b) contracts that an individual holds as an employee may be aggregated. Amounts in section 403(b) contracts that an individual holds as a beneficiary of the same decedent may be aggregated, but such amounts may not be aggregated with amounts held in section 403(b) contracts that the individual holds as the employee or as the beneficiary of another decedent. Distributions from section 403(b) contracts or accounts will not satisfy the minimum distribution requirements for IRAs, nor will distributions from IRAs satisfy the minimum distribution requirements for section 403(b) contracts or accounts.

Par. 4. Section 1.408–8 is added to read as follows:

§ 1.408–8 Distribution requirements for individual retirement plans.

The following questions and answers relate to the distribution rules for IRAs provided in sections 408(a)(6) and 408(b)(3).

Q–1. Is an IRA subject to the distribution rules provided in section 401(a)(9) for qualified plans?

A–1. (a) Yes, an IRA is subject to the required minimum distribution rules provided in section 401(a)(9). In order to satisfy section 401(a)(9) for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2003, the rules of §§ 1.401(a)(9)–1 through 1.401(a)(9)–9 and 1.401(a)(9)–6T for defined contribution plans must be applied, except as otherwise provided in this section. For example, whether the 5–year rule or the life expectancy rule applies to distributions after death occurring before the IRA owner's required beginning date is determined in accordance with § 1.401(a)(9)–3 and the rules of § 1.401(a)(9)–4 apply for purposes of determining an IRA owner's designated beneficiary. Similarly, the amount of the minimum distribution required for each calendar year from an individual account is determined in accordance with § 1.401(a)(9)–5. For purposes of this section, the term IRA means an individual retirement account or annuity described in section 408(a) or (b). The IRA owner is the individual for whom an IRA is originally established by contributions for the benefit of that individual and that individual's beneficiaries.

(b) For purposes of applying the required minimum distribution rules in §§ 1.401(a)(9)–1 through 1.401(a)(9)–9 and 1.401(a)(9)–6T for qualified plans, the IRA trustee, custodian, or issuer is treated as the plan administrator, and the IRA owner is substituted for the employee.

(c) See A–14 and A–15 of § 1.408A–6 for rules under section 401(a)(9) that apply to a Roth IRA.

Q–2. Are IRAs that receive employer contributions under a simplified employee pension (defined in section 408(k)) or a SIMPLE IRA (defined in section 408(p)) treated as IRAs for purposes of section 401(a)(9)?

A–2. Yes, IRAs that receive employer contributions under a simplified employee pension (defined in section 408(k)) or a SIMPLE plan (defined in section 408(p)) are treated as IRAs, rather than employer plans, for purposes of section 401(a)(9) and are, therefore, subject to the distribution rules in this section.

Q–3. In the case of distributions from an IRA, what does the term *required beginning date* mean?

A–3. In the case of distributions from an IRA, the term *required beginning date* means April 1 of the calendar year following the calendar year in which the individual attains age 70½.

Q–4. What portion of a distribution from an IRA is not eligible for rollover because the amount is a required minimum distribution?

A–4. The portion of a distribution that is a required minimum distribution from an IRA and thus not eligible for rollover is determined in the same manner as provided in A–7 of § 1.402(c)–2 for distributions from qualified plans. For example, if a minimum distribution is required under section 401(a)(9) for a calendar year, an amount distributed during a calendar year from an IRA is treated as a

required minimum distribution under section 401(a)(9) to the extent that the total required minimum distribution for the year under section 401(a)(9) for that IRA has not been satisfied. This requirement may be satisfied by a distribution from the IRA or, as permitted under A–9 of this section, from another IRA.

Q–5. May an individual's surviving spouse elect to treat such spouse's entire interest as a beneficiary in an individual's IRA upon the death of the individual (or the remaining part of such interest if distribution to the spouse has commenced) as the spouse's own account?

A–5. (a) The surviving spouse of an individual may elect, in the manner described in paragraph (b) of this A–5, to treat the spouse's entire interest as a beneficiary in an individual's IRA (or the remaining part of such interest if distribution thereof has commenced to the spouse) as the spouse's own IRA. This election is permitted to be made at any time after the individual's date of death. In order to make this election, the spouse must be the sole beneficiary of the IRA and have an unlimited right to withdraw amounts from the IRA. If a trust is named as beneficiary of the IRA, this requirement is not satisfied even if the spouse is the sole beneficiary of the trust. If the surviving spouse makes the election, the required minimum distribution for the calendar year of the election and each subsequent calendar year is determined under section 401(a)(9)(A) with the spouse as IRA owner and not section 401(a)(9)(B) with the surviving spouse as the deceased IRA owner's beneficiary. However, if the election is made in the calendar year containing the IRA owner's death, the spouse is not required to take a required minimum distribution as the IRA owner for that calendar year. Instead, the spouse is required to take a required minimum distribution for that year, determined with respect to the deceased IRA owner under the rules of A–4(a) of § 1.401(a)(9)–5, to the extent such a distribution was not made to the IRA owner before death.

(b) The election described in paragraph (a) of this A–5 is made by the surviving spouse redesignating the account as an account in the name of the surviving spouse as IRA owner rather than as beneficiary. Alternatively, a surviving spouse eligible to make the election is deemed to have made the election if, at any time, either of the following occurs —

(1) Any amount in the IRA that would be required to be distributed to the surviving spouse as beneficiary under section 401(a)(9)(B) is not distributed within the time period required under section 401(a)(9)(B); or

(2) Any additional amount is contributed to the IRA which is subject, or deemed to be subject, to the lifetime distribution requirements of section 401(a)(9)(A).

(c) The result of an election described in paragraph (b) of this A–5 is that the surviving spouse shall then be considered the IRA owner for whose benefit the trust is maintained for all purposes under the Internal Revenue Code (*e.g.*, section 72(t)).

Q–6. How is the benefit determined for purposes of calculating the required minimum distribution from an IRA?

A–6. For purposes of determining the minimum distribution required to be made from an IRA in any calendar year, the account balance of the IRA as of December 31 of the calendar year immediately preceding the calendar year for which distributions are required to be made is substituted in A–3 of § 1.401 (a)(9)–5 for the account balance of the employee. Except as provided in A–7 and A–8 of this section, no adjustments are made for contributions or distributions after that date.

Q–7. What rules apply in the case of a rollover to an IRA of an amount distributed by a qualified plan or another IRA?

A–7. If the surviving spouse of an employee rolls over a distribution from a qualified plan, such surviving spouse may elect to treat the IRA as the spouse's own IRA in accordance with the provisions in A–5 of this section. In the event of any other rollover to an IRA of an amount distributed by a qualified plan or another IRA, the rules in §1.401(a)(9)–7 will apply for purposes of determining the account balance for the receiving IRA and the required minimum distribution from the receiving IRA. However, because the value of the account balance is determined as of December 31 of the year preceding the year for which the required minimum distribution is being determined and not as of a valuation date in the preceding year, the account balance of the receiving IRA is only adjusted if the amount is not received in the calendar year in which the amount rolled over is distributed. In that case, for purposes of determining the required minimum distribution for the calendar year in which such amount is actually received, the account balance of the receiving IRA as of December 31 of the preceding year must be adjusted by the amount received in accordance with A–2 of §1.401(a)(9)–7.

Q–8. What rules apply in the case of a transfer (including a recharacterization) from one IRA to another?

A–8. (a) *General rule*. In the case of a trustee-to-trustee transfer from one IRA to another IRA that is not a distribution and rollover, the transfer is not treated as a distribution by the transferor IRA for purposes of section 401(a)(9). Accordingly, the minimum distribution requirement with respect to the transferor IRA must still be satisfied. Except as provided in paragraph (b) of this A–8 for recharacterizations, after the transfer the employee's account balance and the required minimum distribution under the transferee IRA are determined in the same manner as an account balance and required minimum distribution are determined under an IRA receiving a rollover contribution under A–7 of this section.

(b) *Recharacterizations*. If an amount is contributed to a Roth IRA that is a conversion contribution or failed conversion contribution and that amount (plus net income allocable to that amount) is transferred to another IRA (transferee IRA) in a subsequent year as a recharacterized contribution, the recharacterized contribution (plus allocable net income) must be added to the December 31 account balance of the transferee IRA for the year in which the conversion or failed conversion occurred.

Q–9. Is the required minimum distribution from one IRA of an owner permitted to be distributed from another IRA in order to satisfy section 401(a)(9)?

A–9. Yes, the required minimum distribution must be calculated separately for each IRA. The separately calculated amounts may then be totaled and the total distribution taken from any one or more of the individual's IRAs under the rules set forth in this A–9. Generally, only

amounts in IRAs that an individual holds as the IRA owner may be aggregated. However, amounts in IRAs that an individual holds as a beneficiary of the same decedent and which are being distributed under the life expectancy rule in section 401(a)(9)(B)(iii) or (iv) may be aggregated, but such amounts may not be aggregated with amounts held in IRAs that the individual holds as the IRA owner or as the beneficiary of another decedent. Distributions from section 403(b) contracts or accounts will not satisfy the distribution requirements from IRAs, nor will distributions from IRAs satisfy the distribution requirements from section 403(b) contracts or accounts. Distributions from Roth IRAs (defined in section 408A) will not satisfy the distribution requirements applicable to IRAs or section 403(b) accounts or contracts and distributions from IRAs or section 403(b) contracts or accounts will not satisfy the distribution requirements from Roth IRAs.

Q–10. Is any reporting required by the trustee, custodian, or issuer of an IRA with respect to the minimum amount that is required to be distributed from that IRA?

A–10. Yes, the trustee, custodian, or issuer of an IRA is required to report information with respect to the minimum amount required to be distributed from the IRA for each calendar year to individuals or entities, at the time, and in the manner, prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) as well as the applicable Federal tax forms and accompanying instructions.

Q–11. Which amounts distributed from an IRA are taken into account in determining whether section 401(a)(9) is satisfied?

A–11. (a) *General rule*. Except as provided in paragraph (b) of this A–11, all amounts distributed from an IRA are taken into account in determining whether section 401(a)(9) is satisfied, regardless of whether the amount is includible in income.

(b) Amounts not taken into account. The following amounts are not taken into account in determining whether the required minimum amount with respect to an IRA for a calendar year has been distributed —

(1) Contributions returned pursuant to section 408(d)(4), together with the income allocable to these contributions;

(2) Contributions returned pursuant to section 408(d)(5);

(3) Corrective distributions of excess simplified employee pension contributions under section 408(k)(6)(C), together with the income allocable to these distributions; and

(4) Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See § 601.601(d)(2)(ii)(b) of this chapter.

PART 54 — PENSION EXCISE TAXES

Par. 5. The authority for part 54 is amended by adding the following citation to read in part as follows:

Authority: 26 U.S.C. 7805 ***

Section 54.4974–2 also issued under 26 U.S.C. 4974. ***

Par. 6. Section after § 54.4974–2 is added to read as follows:

§ 54.4974–2 Excise tax on accumulations in qualified retirement plans.

Q–1. Is any tax imposed on a payee under any qualified retirement plan or any eligible deferred compensation plan (as defined in section 457(b)) to whom an amount is required to be distributed for a taxable year if the amount distributed during the taxable year is less than the required minimum distribution?

A–1. Yes, if the amount distributed to a payee under any qualified retirement plan or any eligible deferred compensation plan (as defined in section 457(b)) for a calendar year is less than the required minimum distribution for such year, an excise tax is imposed on such payee under section 4974 for the taxable year beginning with or within the calendar year during which the amount is required to be distributed. The tax is equal to 50 percent of the amount by which such required minimum distribution exceeds the actual amount distributed during the calendar year. Section 4974 provides that this tax shall be paid by the payee. For purposes of section 4974, the term *required minimum distribution* means the minimum distribution amount required to be distributed pursuant to section 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3), or 457(d)(2), as the case may be, and the regulations thereunder. Except as otherwise provided in A–6 of this section, the required minimum distribution for a calendar year is the required minimum distribution amount required to be distributed during the calendar year. A–6 of this section provides a special rule for amounts required to be distributed by an employee's (or individual's) required beginning date.

Q–2. For purposes of section 4974, what is a qualified retirement plan?

A–2. For purposes of section 4974, each of the following is a qualified retirement plan —

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) An annuity contract, custodial account, or retirement income account described in section 403(b);

(d) An individual retirement account described in section 408(a) (including a Roth IRA described in section 408A);

(e) An individual retirement annuity described in section 408(b) (including a Roth IRA described in section 408A); or

(f) Any other plan, contract, account, or annuity that, at any time, has been treated as a plan, account, or annuity described in paragraphs (a) through (e) of this A–2, whether or not such plan, contract, account, or annuity currently satisfies the applicable requirements for such treatment.

Q–3. If a payee's interest under a qualified retirement plan is in the form of an individual account, how is the required minimum distribution for a given calendar year determined for purposes of section 4974?

A–3. (a) *General rule*. If a payee's interest under a qualified retirement plan is in the form of an individual account and distribution of such account is not being made under an annuity contract purchased in accordance with A–4 of § 1.401(a)(9)–6T, the amount of the required minimum distribution for any calendar year for purposes of section 4974 is the required minimum distribution amount

required to be distributed for such calendar year in order to satisfy the minimum distribution requirements in § 1.401 (a)(9)–5 as provided in the following (whichever is applicable) —

(1) Section 401(a)(9) and §§ 1.401(a)(9)–1 through 1.401(a)(9)–5 and 1.401(a)(9)–7 through 1.401(a)(9)–9 in the case of a plan described in section 401(a) which includes a trust exempt under section 501(a) or an annuity plan described in section 403(a);

(2) Section 403(b)(10) and § 1.403 (b)–3 (in the case of an annuity contract, custodial account, or retirement income account described in section 403(b));

(3) Section 408(a)(6) or (b)(3) and § 1.408–8 (in the case of an individual retirement account or annuity described in section 408(a) or (b)); or

(4) Section 457(d) in the case of an eligible deferred compensation plan (as defined in section 457(b)).

(b) *Default provisions*. Unless otherwise provided under the qualified retirement plan (or, if applicable, the governing instrument of the qualified retirement plan), the default provisions in A–4(a) of § 1.401(a)(9)–3 apply in determining the required minimum distribution for purposes of section 4974.

(c) *Five-year rule*. If the 5–year rule in section 401(a)(9)(B)(ii) applies to the distribution to a payee, no amount is required to be distributed for any calendar year to satisfy the applicable enumerated section in paragraph (a) of this A–3 until the calendar year which contains the date 5 years after the date of the employee's death. For the calendar year which contains the date 5 years after the employee's death, the required minimum distribution amount required to be distributed to satisfy the applicable enumerated section is the payee's entire remaining interest in the qualified retirement plan.

Q–4. If a payee's interest in a qualified retirement plan is being distributed in the form of an annuity, how is the amount of the required minimum distribution determined for purposes of section 4974?

A–4. If a payee's interest in a qualified retirement plan is being distributed in the form of an annuity (either directly from the plan, in the case of a defined benefit plan, or under an annuity contract purchased from an insurance company), the amount of the required minimum distribution for purposes of section 4974 will be determined as follows:

(a) *Permissible annuity distribution option*. A permissible annuity distribution option is an annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) which specifically provides for distributions which, if made as provided, would for every calendar year equal or exceed the minimum distribution amount required to be distributed to satisfy the applicable section enumerated in paragraph (a) of A–2 of this section for every calendar year. If the annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) under which distributions to the payee are being made is a permissible annuity distribution option, the required minimum distribution for a given calendar year will equal the amount which the annuity contract (or distribution option) provides is to be distributed for that calendar year.

(b) *Impermissible annuity distribution option*. An impermissible annuity distribution option is an annuity contract (or, in the case of annuity distributions from a defined benefit plan, a distribution option) under which distributions to the payee are being made that specifically provides for distributions which, if made as provided, would for any calendar year be less than the minimum distribution amount required to be distributed to satisfy the applicable section enumerated in paragraph (a) of A–3 of this section. If the annuity contract (or, in the case of annuity distributions from a defined benefit plan, the distribution option) under which distributions to the payee are being made is an impermissible annuity distribution option, the required minimum distribution for each calendar year will be determined as follows:

(1) If the qualified retirement plan under which distributions are being made is a defined benefit plan, the minimum distribution amount required to be distributed each year will be the amount which would have been distributed under the plan if the distribution option under which distributions to the payee were being made was the following permissible annuity distribution option:

(i) In the case of distributions commencing before the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the joint and survivor annuity option under the plan for the lives of the employee and the designated beneficiary that provides for the greatest level amount payable to the employee determined on an annual basis. If the plan does not provide such an option or there is no designated beneficiary under the impermissible distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the life annuity option under the plan payable for the life of the employee in level amounts with no survivor benefit.

(ii) In the case of distributions commencing after the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the permissible annuity distribution option is the life annuity option under the plan payable for the life of the designated beneficiary in level amounts. If there is no designated beneficiary, the 5–year rule in section 401(a)(9)(B)(ii) applies. See paragraph (b)(3) of this A–4. The determination of whether or not there is a designated beneficiary and the determination of which designated beneficiary's life is to be used in the case of multiple beneficiaries will be made in accordance with § 1.401(a)(9)–4 and A–7 of § 1.401 (a)(9)–5. If the defined benefit plan does not provide for distribution in the form of the applicable permissible distribution option, the required minimum distribution for each calendar year will be an amount as determined by the Commissioner.

(2) If the qualified retirement plan under which distributions are being made is a defined contribution plan and the impermissible annuity distribution option is an annuity contract purchased from an insurance company, the minimum distribution amount required to be distributed each year will be the amount that would have been distributed in the form of an annuity contract under the permissible annuity distribution option under the plan determined in accordance with paragraph (b)(1) of this A–4 for defined benefit plans. If the defined contribution plan does not provide the applicable permissible annuity distribution option, the

required minimum distribution for each calendar year will be the amount that would have been distributed under an annuity described in paragraph (b)(2)(i) or (ii) of this A–4 purchased with the employee's or individual's account used to purchase the annuity contract that is the impermissible annuity distribution option.

(i) In the case of distributions commencing before the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity is a joint and survivor annuity for the lives of the employee and the designated beneficiary which provides level annual payments and which would have been a permissible annuity distribution option. However, the amount of the periodic payment which would have been payable to the survivor will be the applicable percentage under the table in A–2(c) of § 1.401(a)(9)–6T of the amount of the periodic payment which would have been payable to the employee or individual. If there is no designated beneficiary under the impermissible distribution option for purposes of section 401(a)(9), the annuity is a life annuity for the life of the employee with no survivor benefit which provides level annual payments and which would have been a permissible annuity distribution option.

(ii) In the case of a distribution commencing after the death of the employee, if there is a designated beneficiary under the impermissible annuity distribution option for purposes of section 401(a)(9), the annuity option is a life annuity for the life of the designated beneficiary which provides level annual payments and which would have been a permissible annuity distribution option. If there is no designated beneficiary, the 5–year rule in section 401(a)(9)(B)(ii) applies. See paragraph (b)(3) of this A–4. The amount of the payments under the annuity contract will be determined using the interest rate and actuarial tables prescribed under section 7520 determined using the date determined under A–3 of § 1.401(a)(9)–3 when distributions are required to commence and using the age of the beneficiary as of the beneficiary's birthday in the calendar year that contains that date. The determination of whether or not there is a designated beneficiary and the determination of which designated beneficiary's life is to be used in the case of multiple beneficiaries will be made in accordance with § 1.401(a)(9)–4 and A–7 of § 1.401(a)(9)–5.

(3) If the 5–year rule in section 401(a)(9)(B)(ii) applies to the distribution to the payee under the contract (or distribution option), no amount is required to be distributed to satisfy the applicable enumerated section in paragraph (a) of this A–4 until the calendar year which contains the date 5 years after the date of the employee's death. For the calendar year which contains the date 5 years after the employee's death, the required minimum distribution amount required to be distributed to satisfy the applicable enumerated section is the payee's entire remaining interest in the annuity contract (or under the plan in the case of distributions from a defined benefit plan).

(4) If the plan provides that the required beginning date for purposes of section 401(a)(9) for all employees is April 1 of the calendar year following the calendar year in which the employee attained age 70½ in accordance with paragraph A–2(e) of § 1.401(a)(9)–2, the required minimum distribution for each calendar year for an employee who is not a 5–percent owner for purposes of this section will be the lesser of the amount determined based on the required beginning date as set forth in A–2(a) of § 1.401(a)(9)–2 or the required beginning date under the plan. Thus, for example, if an employee dies after attaining age 70½, but before April 1 of the calendar year following the calendar year in which the employee retired, and there is no designated beneficiary as of September 30 of the year following the employee's year of death, required minimum distributions for calendar years after the calendar year containing the employee's date of death may be based on either the applicable distribution period provided under either the 5–year rule of A–1 of § 1.401(a)(9)–3 or the employee's remaining life expectancy as set forth in A–5(c)(3) of § 1.401(a)(9)–5.

Q–5. If there is any remaining benefit with respect to an employee (or IRA owner) after any calendar year in which the entire remaining benefit is required to be distributed under section 401(a)(9), what is the amount of the required minimum distribution for each calendar year subsequent to such calendar year?

A–5. If there is any remaining benefit with respect to an employee (or IRA owner) after the calendar year in which the entire remaining benefit is required to be distributed, the required minimum distribution for each calendar year subsequent to such calendar year is the entire remaining benefit.

Q–6. With respect to which calendar year is the excise tax under section 4974 imposed in the case in which the amount not distributed is an amount required to be distributed by April 1 of a calendar year (by the employee's or individual's required beginning date)?

A–6. In the case in which the amount not paid is an amount required to be paid by April 1 of a calendar year, such amount is a required minimum distribution for the previous calendar year, *i.e.*, for the employee's or the individual's first distribution calendar year. However, the excise tax under section 4974 is imposed for the calendar year containing the last day by which the amount is required to be distributed, *i.e.*, the calendar year containing the employee's or individual's required beginning date, even though the preceding calendar year is the calendar year for which the amount is required to be distributed. There is also a required minimum distribution for the calendar year which contains the employee's or individual's required beginning date. Such distribution is also required to be made during the calendar year which contains the employee's or individual's required beginning date.

Q–7. Are there any circumstances when the excise tax under section 4974 for a taxable year may be waived?

A–7. (a) *Reasonable cause*. The tax under section 4974(a) may be waived if the payee described in section 4974(a) establishes to the satisfaction of the Commissioner the following —

(1) The shortfall described in section 4974(a) in the amount distributed in any taxable year was due to reasonable error; and

(2) Reasonable steps are being taken to remedy the shortfall.

(b) *Automatic waiver*. The tax under section 4974 will be automatically waived, unless the Commissioner determines otherwise, if —

(1) The payee described in section 4974(a) is an individual who is the sole beneficiary and whose required minimum distribution amount for a calendar year is determined under the life expectancy rule described in § 1.401(a)(9)–3 A–3 in the case of an employee's or individual's death before the employee's or individual's required beginning date; and

(2) The employee's or individual's entire benefit to which that beneficiary is entitled is distributed by the end of the fifth calendar year following the calendar year that contains the employee's or individual's date of death.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7808.

Par. 8. In § 602.101, paragraph (b) is amended by adding entries for "1.401(a)(9)–1", "1.401(a)(9)–3", "1.401(a)(9)–4", and "1.403(b)–3" in numerical order to the table to read in part as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.401(a)(9)–1	1545–1573
* * * * *	
1.401(a)(9)–3	1545–1466
* * * * *	
1.401(a)(9)–4	1545–1573
* * * * *	
1.403(b)–3	1545–0996
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved March 26, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 16, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 17, 2002, 67 F.R. 18988)

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, on this page.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, on this page.

Section 1041.—Transfers of Property Between Spouses or Incident to Divorce

26 CFR 1.1041–1T: Treatment of transfer of property between spouses or incident to divorce.

A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse. See Rev. Rul. 2002–22, page 849.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate; and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2002.

Rev. Rul. 2002–25

This revenue ruling provides various prescribed rates for federal income tax purposes for May 2002 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2002–25 TABLE 1

Applicable Federal Rates (AFR) for May 2002

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	3.21%	3.18%	3.17%	3.16%
110% AFR	3.53%	3.50%	3.48%	3.47%
120% AFR	3.86%	3.82%	3.80%	3.79%
130% AFR	4.17%	4.13%	4.11%	4.09%
Mid-Term				
AFR	4.99%	4.93%	4.90%	4.88%
110% AFR	5.49%	5.42%	5.38%	5.36%
120% AFR	6.01%	5.92%	5.88%	5.85%
130% AFR	6.51%	6.41%	6.36%	6.33%
150% AFR	7.54%	7.40%	7.33%	7.29%
175% AFR	8.82%	8.63%	8.54%	8.48%

REV. RUL. 2002–25 TABLE 1—CONTINUED

Applicable Federal Rates (AFR) for May 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Long-Term				
AFR	5.85%	5.77%	5.73%	5.70%
110% AFR	6.45%	6.35%	6.30%	6.27%
120% AFR	7.04%	6.92%	6.86%	6.82%
130% AFR	7.64%	7.50%	7.43%	7.39%

REV. RUL. 2002–25 TABLE 2

Adjusted AFR for May 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	2.56%	2.54%	2.53%	2.53%
Mid-term adjusted AFR	3.98%	3.94%	3.92%	3.91%
Long-term adjusted AFR	5.01%	4.95%	4.92%	4.90%

REV. RUL. 2002–25 TABLE 3

Rates Under Section 382 for May 2002

Adjusted federal long-term rate for the current month	5.01%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.01%

REV. RUL. 2002–25 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for May 2002

Appropriate percentage for the 70% present value low-income housing credit	8.27%
Appropriate percentage for the 30% present value low-income housing credit	3.54%

REV. RUL. 2002–25 TABLE 5

Rate Under Section 7520 for May 2002

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	6.0%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 2032A.—Valuation of Certain Farm, etc., Real Property

26 CFR 20.2032A–4: Method of valuing farm real property.

Special use value; farms; interest rates. The 2002 interest rates to be used in computing the special use value of farm real property for which an election is made under section 2032A of the Code are listed for estates of decedents.

Rev. Rul. 2002–26

This revenue ruling contains a list of the average annual effective interest rates on new loans under the Farm Credit Bank system. This revenue ruling also contains a list of the states within each Farm Credit Bank District.

Under § 2032A(e)(7)(A)(ii) of the Internal Revenue Code, rates on new Farm Credit Bank loans are used in computing the special use value of real property used as a farm for which an election is made under § 2032A. The rates in this revenue ruling may be used by estates that value farmland under § 2032A as of a date in 2002.

Average annual effective interest rates, calculated in accordance with § 2032A (e)(7)(A) and § 20.2032A–4(e) of the Estate Tax Regulations, to be used under § 2032A(e)(7)(A)(ii), are set forth in the accompanying Table of Interest Rates (Table 1). The states within each Farm Credit Bank District are set forth in the accompanying Table of Farm Credit Bank Districts (Table 2).

Rev. Rul. 81–170 (1981–1 C.B. 454) contains an illustrative computation of an average annual effective interest rate. The rates applicable for valuation in 2001 are in Rev. Rul. 2001–21 (2001–1 C.B. 1144). For rate information for years prior to 2001, see Rev. Rul. 2000–26 (2000–1 C.B. 1124), and other revenue rulings that are referenced therein.

DRAFTING INFORMATION

The principal author of this revenue ruling is Lane Damazo of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Lane Damazo at (202) 622–3090 (not a toll-free call).

REV. RUL. 2002–26 TABLE 1

TABLE OF INTEREST RATES
(Year of Valuation 2002)

Farm Credit Bank District in Which Property Is Located	Interest Rate
Columbia	9.68
Omaha/Spokane	7.77
Sacramento	7.66
St. Paul	7.88
Springfield	8.16
Texas	7.80
Wichita	7.96

REV. RUL. 2002–26 TABLE 2

TABLE OF FARM CREDIT BANK DISTRICTS

District	States
Columbia	Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia.
Omaha/Spokane	Alaska, Idaho, Iowa, Montana, Nebraska, Oregon, South Dakota, Washington, Wyoming.
Sacramento	Arizona, California, Hawaii, Nevada, Utah.
St. Paul	Arkansas, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, North Dakota, Ohio, Tennessee, Wisconsin.
Springfield	Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont.
Texas	Alabama, Louisiana, Mississippi, Texas.
Wichita	Colorado, Kansas, New Mexico, Oklahoma.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2002. See Rev. Rul. 2002–25, page 904.

Part III. Administrative, Procedural, and Miscellaneous

Notice of Proposed Rules Regarding Employment Taxation of Transfers Incident to Divorce

Notice 2002–31

I. Overview and Purpose

This notice sets forth the contents of a proposed revenue ruling explaining how the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (income tax withholding) apply to a transfer of interests in nonstatutory stock options and nonqualified deferred compensation to a former spouse incident to a divorce. The proposed revenue ruling also contains proposed reporting requirements with respect to such transferred interests.

This notice solicits comments regarding the proposed revenue ruling. The Department of the Treasury and the Internal Revenue Service anticipate issuing a final revenue ruling after the comments have been considered.

II. Proposed Revenue Ruling

The facts in the proposed revenue ruling below are the same as in Rev. Rul. 2002–22, page 849, this Bulletin, and are restated here for convenience.

PROPOSED REVENUE RULING

ISSUES

(1) What is the effect upon taxation under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (income tax withholding) of a transfer of interests in nonstatutory stock options and nonqualified deferred compensation to a former spouse incident to divorce?

(2) What is the appropriate reporting of income and/or wages recognized with respect to nonstatutory stock options and nonqualified deferred compensation transferred to a former spouse incident to divorce?

FACTS

Prior to their divorce in 2002, *A* and *B* were married individuals residing in State *X* who used the cash receipts and disbursements method of accounting.

A is employed by Corporation *Y*. Prior to the divorce, *Y* issued nonstatutory stock options to *A* as part of *A*'s compensation. The nonstatutory stock options did not have a readily ascertainable fair market value within the meaning of section 1.83–7(b) of the Income Tax Regulations at the time granted to *A*, and thus no amount was included in *A*'s gross income with respect to those options at the time of grant.

Y maintains two unfunded, deferred compensation plans under which *A* earns the right to receive post-employment payments from *Y*. Under one of the deferred compensation plans, participants are entitled to payments based on the balance of individual accounts of the kind described in section 31.3121(v)(2)–1(c)(1)(ii) of the Employment Tax Regulations. By the time of *A*'s divorce from *B*, *A* had an account balance of $\$100x$ under that plan. Under the second deferred compensation plan maintained by *Y*, participants are entitled to receive single sum or periodic payments following separation from service based on a formula reflecting their years of service and compensation history with *Y*. By the time of *A*'s divorce from *B*, *A* had accrued the right to receive a single sum payment of $\$50x$ under that plan following *A*'s termination of employment with *Y*. *A*'s contractual rights to the deferred compensation benefits under these plans were not contingent on *A*'s performance of future services for *Y*.

Under the law of State *X*, stock options and unfunded deferred compensation rights earned by a spouse during the period of marriage are marital property subject to equitable division between the spouses in the event of divorce. Pursuant to the property settlement incorporated into their judgment of divorce, *A* transferred to *B* (1) one-third of the nonstatutory stock options issued to *A* by *Y*, (2) the right to receive deferred compensation payments from *Y* under the account balance plan based on $\$75x$ of *A*'s account balance under that plan at the time of the divorce, and (3) the right to receive a single sum payment of $\$25x$ from *Y* under the other deferred compensation plan upon *A*'s termination of employment with *Y*.

In 2006, *B* exercises all of the transferred stock options and receives *Y* stock with a fair market value in excess of the exercise price of the options. In 2011, *A* terminates employment with *Y*, and *B* receives a single sum payment of $\$150x$ from the account balance plan and a single sum payment of $\$25x$ from the other deferred compensation plan.

LAW AND ANALYSIS

Rev. Rul. 2002–22, page 849, concludes that a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. The ruling also concludes that the former spouse, rather than the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

FICA Wages

Sections 3101 and 3111 impose FICA taxes on "wages" as that term is defined in section 3121(a). FICA taxes consist of the Old-Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed on both the employer and employee. Sections 3101(a) and 3101(b) impose the employee portions of the social security tax and the Medicare tax, respectively. Sections 3111(a) and (b) impose the employer portions of the social security tax and the Medicare tax, respectively.

Section 3102(a) provides that the employee portion of FICA taxes must be collected by the employer of the taxpayer by deducting the amount of the tax from wages as and when paid. Section 31.3102(a)–1(a) of the Employment Tax Regulations provides that the employer is required to collect the tax, notwithstanding that wages are paid in something other than money. Section 3102(b) provides that every employer required to deduct the FICA employee tax is liable for the payment of that tax, and is indemnified against the claims and demands of any person for the amount of any such payment made by such employer.

The term "wages" is defined in section 3121(a) for FICA purposes as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Section 3121(b) defines "employment" as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Section 31.3121(a)–1(e) of the regulations provides that in general the medium in which the remuneration is paid is immaterial. It may be paid in cash or other than in cash. Remuneration paid in any medium other than cash is computed on the basis of the fair market value of such items at the time of payment.

Under section 3121(v)(2), amounts deferred under a nonqualified deferred compensation plan generally are to be taken into account when the services are performed or, if later, when there is no substantial risk of forfeiture. To the extent benefit payments under a nonqualified deferred compensation plan are attributable to amounts deferred under the plan that have been taken into account for FICA tax purposes, the benefit payments are not treated as FICA wages. To the extent benefit payments are attributable to an amount deferred that has not been taken into account for FICA tax purposes, then the benefit payments are treated as FICA wages. *See* section 31.3121(v)(2)–1(d)(1)(ii) of the regulations.

In the Social Security Amendments of 1983, Public Law No. 98–21 (1983–2 C.B. 309), Congress added language to section 3121(a) providing that nothing in the income tax withholding regulations that provides an exclusion from wages for income tax withholding purposes shall be construed to require a similar exclusion from wages for FICA purposes. The legislative history in connection with this provision states that "[s]ince the [social] security system has objectives which are significantly different from the objective underlying the income tax withholding rules, the committee believes that amounts exempt from income tax withholding should not be exempt from FICA tax unless Congress provides an explicit tax exclusion." S. Rep. No. 23, 98th Cong., 1st Sess. at 42 (1983).

The fact that payments are includible in the gross income of an individual other than an employee does not remove the payments from FICA wages. *See* Rev. Rul. 71–116 (1971–1 C.B. 277) holding that payments of wages to an employee in a community property state are FICA wages although one-half of the wages is includible in the gross income of the nonemployee spouse. *See also* Rev. Rul. 86–109 (1986–2 C.B. 196) which holds that payments of remuneration for employment made after the death of an employee and in the calendar year of the death are wages for FICA tax purposes, although the amounts are includible in the gross income of the recipient and not the employee.

Rev. Rul. 2002–22 holds that, upon the exercise of nonstatutory stock options obtained by a nonemployee spouse pursuant to divorce, the property transferred to the nonemployee spouse by the employer has the same character and is includible in the income of the nonemployee spouse under section 83(a) to the same extent as the property would have been includible in the income of the employee spouse had the options been retained and exercised by the employee spouse. Rev. Rul. 2002–22 further holds that nonqualified deferred compensation, the right to which is obtained by a nonemployee spouse pursuant to divorce, paid or made available to the nonemployee spouse has the same character and is includible in the income of the nonemployee spouse to the same extent as the compensation would have been includible in the income of the employee spouse had the compensation been paid or made available to the employee spouse. Nothing in section 1041 excludes payments to a person other than an employee from wages for purposes of FICA. In the absence of a specific provision that would exclude these payments from FICA wages, the compensation realized on the exercise of the stock options by the nonemployee spouse and the deferred compensation paid or made available to the nonemployee spouse retain their character as wages of the employee spouse for purposes of FICA. Thus, the payment of such remuneration is subject to FICA to the same extent as if paid to the employee spouse.

Accordingly, the nonqualified deferred compensation paid or made available to the former spouse remains subject to the rules of section 3121, including section 3121(v) and the regulations thereunder, to determine when and whether FICA tax is applicable. Thus, to the extent the amount deferred has been previously taken into account for FICA purposes, the distribution to the former spouse of the proceeds of the account balance plan would not be treated as wages for FICA tax purposes. However, to the extent the amount deferred has not been previously taken into account for FICA tax purposes, the distribution to the former spouse of the proceeds of the account balance plan would be wages of the employee for FICA tax purposes. Similarly, under section 3121 and the regulations thereunder, a former spouse's exercise of nonqualified stock options results in FICA wages of the employee to the extent that the fair market value of the stock received pursuant to the exercise of the option exceeds the option exercise price.

To the extent the distributed payments are FICA wages, the employee FICA tax is deducted from the payment made to the transferee. The amount includible in the gross income of the transferee is not reduced by any FICA withholding from the payments (including transfers of property) to the transferee. *See* Rev. Rul. 86–109 and Rev. Rul. 71–116.

Because *A* was the service performer and the remuneration relates to *A*'s service in employment with *Y*, the wages, although paid to *B*, are FICA wages of *A*. *See* Rev. Rul. 71–116. Thus, because the payments are wages for FICA tax purposes, the payments are reportable by *Y* as social security wages and Medicare wages on a Form W-2, *Wage and Tax Statement*, issued for *A*, and the social

security tax withheld and Medicare tax withheld are also reportable on the Form W–2 for *A*. *Y* may take into account other wages previously paid to *A* in that calendar year in determining whether these distributions are excepted from social security wages under section 3121(a)(1), the maximum social security wage base exception. Finally, these payments should not be included in Box 1, Wages, tips, other compensation, nor should any amount be reflected in Box 2, Federal income tax withheld, of the Form W–2 issued to *A* with respect to these payments.

FUTA

The FUTA taxation provisions applicable with respect to nonqualified stock options and nonqualified deferred compensation plans are similar to the FICA provisions, except that only the employer pays the tax imposed under FUTA. *See* sections 3301, 3306(b), and 3306(r)(2) and the regulations thereunder. Because of the similar statutory provisions, FUTA taxation applies at the same time and in the same manner as FICA. To the extent wage taxation applies, the wages are FUTA wages of the employee *A*, subject to the maximum wage base contained in section 3306(b)(1). As with FICA, wages previously paid to the employee during the calendar year may be taken into account in determining whether these amounts qualify for the FUTA maximum wage base exception.

Income Tax Withholding

Section 3402(a) of the Code, relating to income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures.

Section 3401(a) provides that "wages" for income tax withholding purposes means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions not pertinent to this ruling.

Under section 31.3402(a)–1(c) of the regulations, an employer is required to deduct and withhold the tax notwithstanding that the wages are paid in something other than money (for example, wages paid in stock or bonds) and to pay over the tax in money. If the wages are paid in property other than money, the employer should make necessary arrangements to insure that the amount of the tax required to be withheld is available for payment in money.

Section 31 provides that the amount withheld from wages as income tax withholding will be allowed to the "recipient of the income" as a credit against the income taxes imposed by Subtitle A. Section 1.31–1(a) of the Income Tax Regulations provides that the "recipient of the income" for purposes of the section 31 credit is the individual who is subject to income taxes upon the wages from which the tax was withheld. For example, if an employee spouse and nonemployee spouse are domiciled in a community property state and file separate income tax returns, each reporting for income tax purposes one-half of the wages received by the employee spouse, each spouse is entitled to one-half of the credit allowable for the tax withheld at the source with respect to the wages.

Because the compensatory interests transferred under section 1041 to the nonemployee spouse pursuant to the divorce remain taxable for employment tax purposes to the same extent as if retained by the employee spouse, the income recognized by the nonemployee spouse with respect to the exercise of the nonqualified stock options and the distributions from the nonqualified deferred compensation plans are remuneration for employment and wages for purposes of income tax withholding under section 3402. Pursuant to section 1.31–1(a) of the regulations, because the income recognized with respect to this compensation is includible in the gross income of the nonemployee spouse, the nonemployee spouse is entitled to the credit for the income tax withheld with respect to these wage payments.

Reporting of payments

Section 6051 requires payors of remuneration to an employee to report those payments on Form W–2, *Wage and Tax Statement*. Because the former spouse is not an employee, the reporting requirements of section 6051 do not apply.

Section 6041(a) requires that all persons engaged in a trade or business who make a payment to a third party during the course of such business must file a return with the IRS, reporting all payments totaling $600 or more in a taxable year, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits and income. In this case, pursuant to section 6041(a), *Y* must file an information return reporting both the income *B* realized from *B*'s exercise of the nonstatutory stock options and the payments made to *B* from the deferred compensation plans.

Under section 31.6051–1(a)(1) of the regulations, the wages of an employee that are subject to social security and Medicare taxes are included in the appropriate boxes on the Form W–2 issued to the employee. *See also* Rev. Rul. 71–116.

Because there is no provision for the issuance of Form W–2 in the name of a nonemployee spouse, the income realized upon the exercise of the nonqualified stock options would be reportable to the nonemployee spouse by *Y* on Form 1099–MISC, *Miscellaneous Income*, issued to the nonemployee spouse, in Box 3, Other Income, with the income tax withheld reported in Box 4, Federal income tax withheld. The payments to the nonemployee spouse *B* from the nonqualified deferred compensation plans and the withholding thereon would also be reportable by *Y* on a Form 1099–MISC in Box 3, with the income tax withheld reported in Box 4.

Social security wages, social security tax withheld, Medicare wages, and Medicare taxes withheld, if applicable, are reported on the employee spouse's Form W–2 as described above.

Employers would report the income tax withholding on wages paid to the nonemployee spouse on Form 945, *Annual Return of Withheld Federal Income Tax*. The social security and Medicare tax paid with respect to these wages of the employee spouse would be reported on Form 941, *Employer's Quarterly Federal Tax Return*. FUTA tax with respect to wages of the employee spouse would be reported on Form 940, *Employer's Annual Federal Unemployment Tax Return*.

HOLDINGS

(1) The transfer of interests in nonstatutory stock options and nonqualified deferred compensation from the employee spouse to the nonemployee spouse incident to divorce does not result in a payment of wages for FICA and FUTA tax purposes.

The nonstatutory stock options are subject to FICA and FUTA taxes at the time of exercise by the nonemployee spouse to the same extent as if the options had been retained by the employee spouse and exercised by the employee spouse. The nonqualified deferred compensation also remains subject to FICA and FUTA taxes to the same extent as if the rights to the compensation had been retained by the employee spouse. To the extent FICA and FUTA taxation apply, the wages are the wages of the employee spouse. The employee portion of the FICA taxes is deducted from the wages as and when the wages are taken into account for FICA tax purposes.

The income recognized by the nonemployee spouse with respect to the exercise of the nonqualified stock options is subject to withholding under section 3402. The amounts distributed to the nonemployee spouse from the nonqualified deferred compensation plans are also subject to withholding under section 3402. Pursuant to section 31, the nonemployee spouse is entitled to the credit allowable for the income tax withheld at the source on these wages.

(2) The social security wages, Medicare wages, social security taxes withheld, and Medicare taxes withheld, if applicable, are reportable on a Form W–2 with the name, address, and social security number of the employee spouse. However, no amount is includible in Box 1 and Box 2 of the employee's Form W–2 with respect to these payments. The income with respect to the exercise of the nonqualified stock option by the nonemployee spouse and the distributions from the nonqualified deferred compensation plans to the nonemployee spouse are reportable in Box 3 as other income on a Form 1099–MISC with the name, address, and social security number of the nonemployee spouse. Income tax withholding with respect to these payments of wages is included in Box 4, Federal income tax withheld.

Income tax withholding on payments to the nonemployee spouse is included on a Form 945 filed by *Y*. The social security tax and Medicare tax is reported on *Y*'s Form 941, and the FUTA tax is reported on *Y*'s Form 940.

III. Request for Comments

Comments are requested regarding the proposed FICA, FUTA, income tax withholding, and reporting obligations with respect to transfers of interests in nonstatutory stock options and nonqualified deferred compensation incident to divorce. All comments will be available for public inspection and copying. Comments must be submitted by July 15, 2002. Comments should reference Notice 2002–31, and be addressed to:

Associate Chief Counsel
(Tax Exempt and Government Entities)
CC:TEGE
Attn: Employment Taxation of Transfers Incident to Divorce
Room 5214
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, DC 20224

In addition, comments may be submitted electronically via the Internet by sending them in an e-mail to *notice.comments@irscounsel.treas.gov* and specifying the comments concern Notice 2002–31.

IV. Proposed Effective Date of Proposed Revenue Ruling

It is proposed that the revenue ruling described above be effective January 1 of the calendar year beginning not less than 120 days after the publication of the conclusions proposed in this notice as a revenue ruling or other document. For periods before the effective date, it is expected that the revenue ruling will provide relief to employers for reasonable, good faith interpretations, including the interpretation in the proposed revenue ruling. However, with respect to compensation that is transferred to a spouse incident to divorce, it is expected that failure to treat nonqualified stock option compensation, or amounts deferred under a nonqualified deferred compensation plan, as subject to FICA will not be considered a reasonable, good faith interpretation.

Drafting Information

The principal author of this notice is A. G. Kelley of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from Treasury and the Service participated in its development. For further information regarding this notice, contact A. G. Kelley at (202) 622–6040 (not a toll-free call).

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26 CFR 601.201: Rulings and determination letters (Also, Part I, § 401; § 1.401(a)–2.)

Rev. Proc. 2002–21

SECTION 1. INTRODUCTION

.01 *Introduction.* This revenue procedure describes steps that may be taken to ensure the qualified status of defined contribution retirement plans maintained by professional employer organizations (PEOs) for the benefit of Worksite Employees. PEOs are also commonly known as employee leasing organizations.

.02 *Potential for plan disqualification.* The employment relationship between workers and the employer maintaining a plan is fundamental to whether a plan is qualified under § 401(a) of the Internal Revenue Code. The determination of whether an employment relationship exists depends on the facts and circumstances of each particular case. If a retirement plan provides benefits for individuals who are not employees of the employer maintaining the plan, the plan does not satisfy the exclusive benefit rule contained in § 401(a)(2), and therefore could be disqualified.

03. *Relief from disqualification of plan.* The Service recognizes the complexity involved in the determination of whether a Worksite Employee is the common law employee of the PEO or the client organization (CO), as well as the need of the PEO, the CO, Worksite Employees, and plan administrators for certainty in this area. Accordingly, this revenue procedure provides a framework under which

plans sponsored by PEOs will not be treated as violating the exclusive benefit rule solely because they provide benefits to Worksite Employees. Under the approach provided in this revenue procedure, a PEO that maintains a defined contribution retirement plan may establish a multiple employer plan that benefits Worksite Employees providing services to COs. For PEOs that do not wish to establish a multiple employer plan, the revenue procedure provides transition rules under which the existing PEO plan will be treated as a qualified plan if it is terminated by a specified date.

SECTION 2. PURPOSE

.01 *In general*. The purpose of this revenue procedure is to provide relief with respect to certain defined contribution retirement plans maintained by a PEO ("PEO Retirement Plans") that benefit Worksite Employees.

.02 *Scope of relief*. With regard to PEO Retirement Plans established prior to May 13, 2002, if the requirements of section 5 are met, the Service will not disqualify the PEO Retirement Plan solely on account of an exclusive benefit rule violation under § 401(a)(2) for a plan year beginning before the Compliance Date if that violation results from the PEO Retirement Plan benefitting Worksite Employees who are not the PEO's employees. Relief provided under this revenue procedure applies only with respect to the PEO Retirement Plan for which relief is granted and not to other plans maintained by a CO or the PEO.

.03 *No effect on other law*. The relief provided under this revenue procedure with respect to the provisions of § 401(a) has no effect on the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974 and other provisions of the Internal Revenue Code.

SECTION 3. BACKGROUND

.01 *In general*. An employee leasing arrangement typically involves the interaction among three parties: the PEO, the CO, and the Worksite Employees. In a typical situation, a PEO enters into an agreement with a CO whereby employees become Worksite Employees and continue to provide services to the CO.

.02 *Employment relationship*. The issue of whether a worker is an employee of a particular entity for employment tax purposes is determined by reference to § 3121(d), which incorporates the common law definition of employee. The Supreme Court has also applied this common law definition of employee for purposes of determining whether a worker is an employee entitled to receive benefits under a retirement plan. See *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992). Courts have also found that common law factors are applicable to determine which of two entities is the employer for purposes of retirement plans. The critical issue in determining who is the employer of an individual is which entity has the right to direct and control the individual performing the services. If it is found that the CO, not the PEO, is the employer, the plan maintained by a PEO that benefits Worksite Employees of the CO would fail to satisfy the exclusive benefit rule. See *Professional and Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988).

.03 *Exclusive benefit rule*. Section 401(a)(2) provides that a trust forming a part of a qualified pension, profit-sharing, or stock bonus plan must be a trust established and maintained by an employer for the exclusive benefit of that employer's employees and their beneficiaries ("exclusive benefit rule"). Therefore, a retirement plan that provides benefits for individuals who are not employees of the employer maintaining the plan (and who are not otherwise treated as employees under rules such as those under § 414) violates the exclusive benefit rule and does not satisfy the requirements of § 401(a).

.04 *Leased employees*. Section 414(n) does not permit PEOs to maintain plans for Worksite Employees who are not the common law employees of the PEO. Section 414(n) deals with individuals who are not common law employees of the entity for which they perform services ("recipient") but who might have to be taken into account in determining whether a retirement plan maintained by the recipient satisfies the requirements of § 401(a). Notice 84–11 (1984–2 C.B. 469) provides questions and answers relating to § 414(n). Section 414(n) addresses the relationship between the recipient and the leased workers, but it does not apply to situations in which a worker is the common law employee of the recipient.

.05 *Multiple employer plan*. Section 413(c) provides rules for the qualification of a plan maintained by more than one employer (*i.e.*, a "multiple employer plan"). Under § 413(c)(2), in determining whether a multiple employer plan complies with the exclusive benefit rule, all employees benefitting under the multiple employer plan are treated as the employees of all employers who maintain the plan. Additionally, an employee's service with all of the employers participating in the plan is taken into account for purposes of vesting under § 411 and plan participation under § 410(a). *See* § 413 (c)(1) and (3). Similarly, for purposes of the contribution and benefit limitations of § 415, an employee's compensation from all employers participating in the plan is taken into account. *See* § 1.415–1(e)(1) of the Income Tax Regulations. Other rules apply separately to each participating employer and its employees. For example, nondiscrimination testing under § 401(a)(4) and § 401(k), and coverage testing under § 410(b), are performed separately for each employer maintaining the multiple employer plan. *See* § 1.401(a)(4)–1(c)(4), § 1.413–2(a)(3)(ii) and § 1.401(k)–1(g)(11). Top-heavy requirements under § 416 also apply separately to each employer. *See* § 1.416–1, Q&A G–2.

SECTION 4. RELIEF AVAILABLE

.01 *No disqualification of PEO Retirement Plan*. If a PEO has a PEO Retirement Plan in existence on May 13, 2002, that benefits Worksite Employees, section 5 provides the PEO with the option of either converting the PEO Retirement Plan to a multiple employer plan or terminating the plan. If a PEO timely satisfies the requirements of section 5, the Service will not disqualify its PEO Retirement Plan solely on the grounds that the plan violates or has violated the exclusive benefit rule for plan years beginning before the Compliance Date by benefitting Worksite Employees who are not the PEO's employees.

.02 *Effective Dates*. (1) *Compliance Date*. Except as specifically provided, all

remedial actions and other requirements in section 5 must be completed by the Compliance Date. The Compliance Date is the last day of the first plan year of the PEO Retirement Plan beginning on or after January 1, 2003. For a calendar year plan, the Compliance Date is December 31, 2003.

(2) *PEO Decision Date*. The PEO Decision Date is the date by which the PEO must take specified actions affirming its decision whether to terminate the PEO Retirement Plan or maintain a multiple employer retirement plan that benefits Worksite Employees. The PEO Decision Date is the date that is 120 days after the first day of the plan year beginning on or after January 1, 2003. For a calendar year plan, the PEO Decision Date is May 2, 2003.

.03 *Plan terminations*. For the purpose of determining whether a PEO Retirement Plan or Spinoff Retirement Plan satisfies the qualification requirements in § 401(a) upon plan termination (as described in section 5.06), Worksite Employees may be treated as if they were employees of the PEO.

SECTION 5. REMEDIAL ACTION REQUIRED

.01 *In general*. In order to obtain the relief provided in section 4, the plan sponsor of a PEO Retirement Plan must either terminate the PEO Retirement Plan in accordance with section 5.02, or convert the PEO Retirement Plan into a multiple employer plan ("Multiple Employer Retirement Plan") in accordance with section 5.03.

.02 *Termination Option*. (1) *Termination of PEO Retirement Plan*. If a PEO chooses to terminate a PEO Retirement Plan in accordance with this section, the PEO must adopt a resolution of its board of directors (or, if the PEO is not a corporation, it must take comparable binding action, such as a partnership vote) on or before the PEO Decision Date, providing that the plan will be terminated on or before the Compliance Date. After the date of termination, all assets in the plan's related trust must be distributed as soon as administratively feasible. *See* Rev. Rul. 89–87 (1989–2 C.B. 81). Consequently, the mere discontinuance of contributions under the PEO Retirement Plan is not a termination of the plan and will not satisfy the requirements of this section.

(2) *Notification of COs*. The PEO must provide notice of the options set forth in section 5.02(3) to each CO that has Worksite Employees with accrued benefits in the PEO Retirement Plan. The PEO must specify in the notice the date by which each CO must notify the PEO of the option it selects. This notice must be sent on or before the PEO Decision Date.

(3) *CO Options*. The PEO must provide each CO with all of the following options:

(a) *Transfer of assets and liabilities to CO plans*. The CO may choose to have the assets and liabilities of the PEO Plan that are attributable to Worksite Employees performing services for the CO transferred to a retirement plan of the CO as provided in section 5.04(1). The transfer of assets and liabilities attributable to Worksite Employees performing services for the CO to the CO's plan must be completed on or before the Compliance Date.

(b) *Spinoff of assets and liabilities to a separate plan and termination of that plan*. The CO may choose to have the assets and liabilities of the PEO Retirement Plan that are attributable to its Worksite Employees spun off to a Spinoff Retirement Plan, which is then terminated, as provided in section 5.04(2). The spinoff and termination must be completed on or before the Compliance Date. Plan assets must be distributed as soon as administratively feasible after the plan termination date.

(4) *CO Decision and Implementation*. The CO must provide notice of the selected option to the PEO by a date specified by the PEO. If a CO fails to timely inform the PEO of the option it selected, the PEO must treat the CO as having selected option 5.02(3)(b) (Spinoff and Termination). The PEO must implement the choice made or deemed made by each CO on or before the Compliance Date.

(5) *Determination Letter request*. The PEO must request determination letters on the termination of the PEO Retirement Plan and the Spinoff Retirement Plan. See section 5.06 of this revenue procedure for further information on determination letters on plan terminations.

.03 *Conversion Option*. (1) *Conversion to Multiple Employer Retirement Plan*. A PEO may choose to convert the PEO Retirement Plan to a Multiple Employer Retirement Plan, effective the first day of the first plan year beginning after the Compliance Date. If the PEO chooses this option, the PEO must satisfy the requirements of section 5.03(2) through (6). In addition, the Multiple Employer Retirement Plan must be adopted by those COs that wish to have Worksite Employees participate in the plan. To the extent that a PEO Retirement Plan is converted into a Multiple Employer Retirement Plan, assets and liabilities will remain in the plan and not be distributed to participants.

(2) *Adoption of Plan Amendments*. The PEO must adopt plan amendments necessary to convert the PEO Retirement Plan to a Multiple Employer Retirement Plan on or before the PEO Decision Date. The effective date of the plan amendments adopted by the PEO must be no later than the first day of the first plan year beginning after the Compliance Date.

(3) *Notification of COs*. The PEO must provide notice of the options set forth in section 5.03(4) to each CO that has Worksite Employees with accrued benefits in the PEO Retirement Plan. The PEO must specify in the notice the date by which each CO must notify the PEO of the option it selects. This notice must be sent on or before the PEO Decision Date.

(4) *CO Options*. The PEO must provide each CO with all of the following options:

(a) *Adoption of Multiple Employer Retirement Plan*. The CO may adopt the Multiple Employer Retirement Plan. The CO must adopt the Multiple Employer Retirement Plan by the first day of the first plan year beginning after the Compliance Date (or any earlier date as may be specified by the PEO). If a CO chooses this option, the Worksite Employees performing services for the CO may participate in the Multiple Employer Retirement Plan after its adoption by the CO without causing the plan to fail to satisfy the exclusive benefit rule. If a CO has not adopted the Multiple Employer Retirement Plan by the first day of the first plan year beginning after the Compliance Date (or any earlier date as may be specified by the PEO), the Multiple Employer Retirement Plan may

not accept contributions after the Compliance Date on behalf of the Worksite Employees performing services for the CO. In that event, the assets and liabilities attributable to the COs must be spun off as soon as administratively feasible to a Spinoff Retirement Plan.

(b) *Transfer of assets and liabilities to CO plans*. The CO may choose to have the assets and liabilities of the PEO Retirement Plan that are attributable to its Worksite Employees transferred to a retirement plan of the CO as provided in section 5.04(1). The transfer must be completed on or before the Compliance Date.

(c) *Spinoff of assets and liabilities to a separate plan and termination of that plan*. The CO may choose to have the assets and liabilities of the PEO Retirement Plan that are attributable to its Worksite Employees spun off to a Spinoff Retirement Plan that is then terminated, as provided for in section 5.04(2). The spinoff and termination must occur on or before the Compliance Date. Plan assets must be distributed as soon as administratively feasible after the plan termination date

(5) *CO Decision and Implementation*. The CO must provide notice of the selected option to the PEO by a date specified by the PEO. If a CO fails to timely inform the PEO of the option it selected, the PEO must treat the CO as having selected option 5.03(4)(c) (Spinoff of assets and liabilities). The PEO must implement the choice made or deemed made by each CO on or before the Compliance Date.

(6) *Determination Letter request*. The PEO must request determination letters on the Multiple Employer Retirement Plan and the Spinoff Retirement Plan. See section 7.02 of this revenue procedure for further information on an application for a determination letter on the qualified status of a Multiple Employer Retirement Plan. See section 5.06 of this revenue procedure for further information on determination letters on plan terminations.

.04 *Transfers to CO's plan or Spinoff of CO's assets and liabilities*. This section 5.04 applies if the PEO decides to terminate the PEO Retirement Plan; if a CO chooses to terminate its participation in the PEO Retirement Plan and transfer its attributable assets and liabilities to the CO's plan; or if a CO's attributable assets and liabilities are spun off to a Spinoff Retirement Plan and distributed in connection with the termination of the Spinoff Retirement Plan.

(1) *Transfers to CO's plan*. (a) *Documentation of qualified status of plan maintained by the CO*. If a CO chooses to transfer its attributable assets and liabilities in a PEO's Retirement Plan to the CO's plan, the CO must provide the PEO, on or before a date specified by the PEO, with documentation that the plan to which assets are transferred is a qualified plan established and maintained by the CO. If such documentation is provided, the PEO must transfer the assets and liabilities attributable to the Worksite Employees from the PEO Retirement Plan to the CO's plan before the Compliance Date. If the CO fails to provide the PEO with this documentation, or any other information required by the PEO to effect transfer, on or before the date specified by the PEO, the PEO must utilize the procedures in section 5.04(2).

(b) *Qualified Plan Determination*. For purposes of determining whether a CO maintains a qualified plan, a "qualified plan" is a retirement plan that on or before the Compliance Date either (i) had received a favorable determination, notification, or opinion letter that considered GUST (GUST is an acronym for the Uruguay Round Agreements Act (GATT), the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), the Small Business Job Protection Act of 1996 (SBJPA), the Taxpayer Relief Act of 1997 (TRA'97), the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA'98) and the Community Renewal Tax Relief Act of 2000) or (ii) had submitted a request to the Service for a determination letter that considers GUST.

(2) *Spinoff and termination*. If a CO chooses a spinoff, or fails to timely notify the PEO of its selection, the PEO must implement a spinoff of the assets and liabilities of the PEO's Retirement Plan that are attributable to the CO's Worksite Employees to a Spinoff Retirement Plan. The Spinoff Retirement Plan may receive and hold assets and liabilities attributable to Worksite Employees of all of the COs that selected the spinoff option or failed to timely notify the PEO of a selection. The PEO must then terminate the Spinoff Retirement Plan on or before the Compliance Date and distribute benefits to the Worksite Employees performing services for the COs as soon as administratively feasible after the termination date. For purposes of this revenue procedure, a *spinoff* means a spinoff of plan assets and liabilities attributable to the Worksite Employees performing services for the COs selecting the spinoff option (or failing to timely select an option) from the PEO Retirement Plan to a Spinoff Retirement Plan that satisfies the transfer requirements of § 414(l).

.05 *Methods of providing notice*. Any notice required to be provided under this revenue procedure may be sent by any method, including an electronic medium, that reasonably ensures that the intended recipient will receive timely and adequate notice. For purposes of this revenue procedure, notice sent by United States mail is considered sent as of the date of the United States postmark stamped on the cover in which the notice is mailed.

.06 *Plan terminations*. (1) *Request for determination letter on plan termination*. In choosing any of the options relating to plan terminations, a PEO must request a determination letter on the plan termination. Section 12 of Rev. Proc. 2002–6 (2002–1 I.R.B. 203) explains the procedures for requesting determination letters involving qualification of a plan upon plan termination. The permanency requirement described in § 1.401–1(b)(2) will not be raised as a disqualifying defect for plans being terminated pursuant to this revenue procedure. The request for a determination letter must be made within one year of the date of termination using the applicable provisions of Rev. Proc. 2002–6.

(2) *Distribution treated as being from a qualified plan*. Distributions made to Worksite Employees upon the termination of the PEO Retirement Plan or Spinoff Retirement Plan in accordance with this section will not fail to be eligible for favorable tax treatment accorded distributions from qualified plans (including eligibility for tax-free rollovers) solely because the plan violated the exclusive benefit rule of § 401(a)(2).

.07 *Example*. (i) A PEO maintains a PEO Retirement Plan established in 1994,

and the PEO uses the calendar year for its plan year. The PEO Retirement Plan treats all Worksite Employees performing services for COs as employees of the PEO. There are 75 COs with Worksite Employees benefiting under the PEO Retirement Plan.

(ii) After reviewing the options set forth in section 5, the PEO decides to convert the PEO Retirement Plan to a Multiple Employer Retirement Plan. In accordance with the requirements of section 5.03, on January 31, 2003, the PEO adopts amendments to the PEO Retirement Plan converting the plan to a Multiple Employer Retirement Plan, effective January 1, 2004. On February 14, 2003, the PEO mails notification to each CO that it has decided to convert the PEO Retirement Plan to a Multiple Employer Retirement Plan and explains the options available to the CO as described in section 5.03(4). In its letter to the COs, the PEO explains that each CO has until August 15, 2003, to notify the PEO, in writing, of its choice. The letter explains that if the CO does not notify the PEO of its selected option on or before August 15, 2003, the PEO will treat the CO as having selected the spinoff and termination option. The letter further explains that if a CO elects to adopt the Multiple Employer Retirement Plan, the Plan must be adopted on or before December 1, 2003.

(iii) By August 15, 2003, fifty of the COs with Worksite Employees benefitting under the PEO Retirement Plan notify the PEO of their decision to adopt and maintain the Multiple Employer Retirement Plan for the Worksite Employees. By December 1, 2003, forty-nine of the fifty COs adopted the Multiple Employer Retirement Plan, effective January 1, 2004. In accordance with section 5.03(4)(a) of this revenue procedure, on December 10, 2003, the PEO spins off the assets and liabilities attributable to the one CO that did not timely adopt the Multiple Employer Retirement Plan to a Spinoff Retirement Plan.

(iv) Ten COs timely elect a transfer, in which the assets and liabilities attributable to each CO's Worksite Employees are transferred to a qualified retirement plan established and maintained by each CO, and that satisfy the requirements described in section 5.04(1). The ten COs timely provide all information required to effect the transfer, including documentation of the plans' qualified status. The transfers to each of the CO plans are completed by December 31, 2003.

(v) Ten COs affirmatively elect the spinoff and termination option. The PEO spins off plan assets and liabilities attributable to the Worksite Employees performing services for those COs to the Spinoff Retirement Plan on December 10, 2003.

(vi) The remaining five COs failed to notify the PEO of their choice by August 15, 2003. Therefore, in accordance with requirements in section 5.03(5), each of those COs is treated as having selected the spinoff and termination option as its choice. The PEO spins off the assets and liabilities of these COs to the Spinoff Retirement Plan on December 10, 2003.

(vii) On December 11, 2003, the PEO terminates the Spinoff Retirement Plan. On February 5, 2004, the PEO submits an application for a determination letter on the termination of the Spinoff Retirement Plan. The PEO receives a favorable determination letter on the termination of the plan. As soon as administratively feasible following the termination, distributions are made to the Worksite Employees performing services for the sixteen COs (the one CO that failed to timely adopt the Multiple Employer Retirement Plan, the ten COs that selected the spinoff and termination option, and the five COs that failed to timely notify the PEO of their choice) with assets in the Spinoff Retirement Plan.

(viii) On February 5, 2004, the PEO submits an application for a determination letter on the qualified status of the Multiple Employer Retirement Plan, and subsequently receives such a determination letter from the Service. Because the PEO took all of the steps required in section 5 of the revenue procedure, the PEO Retirement Plan is entitled to the relief set forth in section 4 of the revenue procedure.

.08 *PEOs not electing to take advantage of relief under this revenue procedure.* If a PEO does not, as of the Compliance Date, either terminate the PEO Retirement Plan it maintains for Worksite Employees performing services for COs (as provided for in section 5.02) or convert the PEO Retirement Plan to a Multiple Employer Retirement Plan (as provided for in section 5.03), the relief in this revenue procedure is not available for any violations of the qualification requirements, including violations of the exclusive benefit rule, by PEO Retirement Plan.

.09 *No Reliance on Determination Letters for PEO Retirement Plans.* After the Compliance Date, a PEO may not rely on a determination letter for a PEO Retirement Plan that benefits Worksite Employees performing services for COs, regardless of when the determination letter was issued.

SECTION 6. DEFINITIONS

.01 *PEO Retirement Plan.* The term "PEO Retirement Plan" means a defined contribution plan (including a plan that includes a cash or deferred arrangement described in § 401(k)) intended to satisfy the requirements of § 401(a) or § 403 (a). The definition of a PEO Retirement Plan does not include a plan maintained as a multiple employer plan that has been adopted by a PEO and one or more COs.

.02 *Multiple Employer Retirement Plan.* The term "Multiple Employer Retirement Plan" means a defined contribution plan (including a plan that includes a cash or deferred arrangement described in § 401(k)) intended to satisfy the requirements of § 401(a) or § 403(a), and § 413(c), under which each CO is treated as an employer.

.03 *Spinoff Retirement Plan.* The term "Spinoff Retirement Plan" means a separate plan established by a PEO for the specific purpose of a spinoff and termination as provided for in section 5.04(2).

.04 *Worksite Employees.* The term "Worksite Employees" means employees who receive amounts from a PEO for providing services to a CO pursuant to a service agreement between the PEO and the CO.

.05 *Client Organization.* The term "Client Organization" (CO) means an organization that enters into a service agreement with a PEO under which Worksite Employees provide services to the organization.

SECTION 7. PROCEDURES AND TRANSITIONAL RULE

.01 *Other qualification issues.* (1) *Use of EPCRS.* Plan qualification issues, other than the exclusive benefit issue for which relief is provided under this revenue procedure, may be resolved under the Employee Plans Compliance Resolution System (EPCRS). See Rev. Proc. 2001–17 (2001–1 C.B. 589).

(2) *Transitional relief for PEOs.* For purposes of determining whether a retirement plan maintained by a PEO for the benefit of Worksite Employees of COs satisfies the requirements of § 401(a)(2) prior to the Compliance Date, a PEO may treat Worksite Employees as its employees.

(3) *Transitional Rule for Code section 416.* For purposes of determining whether the Multiple Employer Retirement Plan is top heavy (as defined in § 416(g)(1)(A)(ii)) in its first plan year, the determination date with respect to the first plan year of such plan shall be the last day of such plan year. See § 416(g)(4)(C)(ii).

.02 *Determination letters.* (1) *Determination letter application.* Any application for a determination letter on the qualified status of any Multiple Employer Retirement Plan adopted and maintained by PEOs and COs that are seeking relief under this revenue procedure shall be made under the relevant provisions of Rev. Proc. 2002–6.

(2) *Time of disqualification provision.* For purposes of § 1.401(b)–1(b) the Service will treat the requirement that the PEO adopt a Multiple Employer Retirement Plan by the Compliance Date as a disqualifying provision.

.03 *Pending examinations no bar to relief.* A PEO Retirement Plan under examination by the Service is eligible for the relief provided by this revenue procedure.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–6 is modified.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective on May 13, 2002.

DRAFTING INFORMATION

The principal author of this revenue procedure is Jeanne Royal Singley of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue procedure, please contact the Employee Plans taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Ms. Singley may be reached at 1–202–283–9888 (not a toll-free number).

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26 CFR 1.148–10: Anti-abuse rules and Authority of Commissioner.
(Also Part I, §§ 103, 148, 1.148–1, 148–2, 148–6)

Rev. Proc. 2002–31

SECTION 1. PURPOSE

This final revenue procedure sets forth a safe harbor under which an issue of tax or revenue anticipation bonds will not be treated as outstanding longer than is reasonably necessary to accomplish the governmental purposes of the bonds for purposes of § 1.148–10(a)(4) of the Income Tax Regulations. On August 20, 2001, this revenue procedure was published in proposed form as Notice 2001–49 (2001–34 I.R.B. 188). Public comments were invited concerning the proposed revenue procedure and none were received. This final revenue procedure is unchanged from the proposed revenue procedure.

SECTION 2. BACKGROUND

01. Section 103(a) of the Internal Revenue Code of 1986 provides that, except as provided in section 103(b), gross income does not include interest on any state or local bond.

02. Section 103(b) provides that the exclusion described in section 103(a) does not apply to any arbitrage bond.

03. Section 148(a) provides that an arbitrage bond is any bond issued as part of an issue any portion of the proceeds of which are to be used directly or indirectly—

(1) to acquire higher yielding investments, or

(2) to replace funds which were used directly or indirectly to acquire higher yielding investments.

04. Section 148(c)(1) provides that a bond will not be treated as an arbitrage bond solely by reason of the fact that the proceeds of the issue of which such bond is a part may be invested in higher yielding investments for a reasonable temporary period until such proceeds are needed for the purpose for which such issue was issued.

05. Section 1.148–2(e)(3)(i) of the Income Tax Regulations provides that the proceeds of an issue that are reasonably expected to be allocated to restricted working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date.

06. Section 1.148–2(e)(3)(ii) provides that if an issuer reasonably expects to use tax revenues arising from tax levies for a single fiscal year to redeem or retire an issue, and the issue matures by the earlier of 2 years after the issue date or 60 days after the last date for payment of those taxes without interest or penalty, the temporary period under § 1.148–2(e)(3)(i) is extended until the maturity date of the issue.

07. Section 1.148–1(b) provides that restricted working capital expenditures are working capital expenditures that are subject to the proceeds-spent-last rule in § 1.148–6(d)(3)(i) and are ineligible for any exception to that rule.

08. Section 1.148–10(a)(1) provides that bonds of an issue are arbitrage bonds if an abusive arbitrage device under § 1.148–10(a)(2) is used in connection with the issue.

09. Section 1.148–10(a)(2) provides that any action is an abusive arbitrage device if the action has the effect of (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage and (ii) overburdening the tax-exempt bond market.

10. Section 1.148–10(a)(4) provides that an action overburdens the tax-exempt bond market if it results in issuing more

bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes of the bonds, based on all the facts and circumstances.

11. Under § 1.148–10(a)(4), one factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under § 1.148–1(c)(4)(i)(B). This factor may be outweighed by other factors, however, such as long-term financial distress.

12. Section 1.148–1(c)(4)(i)(A) provides that certain replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that the term of the issue will be longer than is reasonably necessary for the governmental purposes of the issue and that there will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under § 1.148–10.

13. Section 1.148–1(c)(4)(i)(B)(1) provides a safe harbor against the creation of replacement proceeds under § 1.148–1(c)(4)(i)(A) for the portion of an issue that finances restricted working capital expenditures. This safe harbor is met if that portion is not outstanding longer than 2 years.

14. Section 1.148–1(c)(4)(i)(B)(2) provides a safe harbor against the creation of replacement proceeds under § 1.148–1(c)(4)(i)(A) for the portion of an issue (including a refunding issue) that finances or refinances capital projects. This safe harbor is met if that portion has a weighted average maturity that does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects.

15. Section 1.148–10(d) contains examples illustrating the application of the anti-abuse rules of § 1.148–10. Example 2(i) describes a particular transaction in which an issue is deemed to have a longer weighted average maturity than necessary, notwithstanding that the issue satisfies the safe harbor against the creation of replacement proceeds in § 1.148–1(c)(4)(i)(B)(2).

SECTION 3. SCOPE

This revenue procedure applies to an issue of tax or revenue anticipation bonds the proceeds of which qualify for a temporary period for restricted working capital expenditures under § 1.148–2(e)(3).

SECTION 4. SAFE HARBOR

For purposes of § 1.148–10(a)(4), an issue of tax or revenue anticipation bonds within the scope of this revenue procedure will not be treated as outstanding longer than is reasonably necessary to accomplish the governmental purposes of those bonds if the final maturity date of the issue is not later than the end of the applicable temporary period under § 1.148–2(e)(3)(i) or § 1.148–2(e)(3)(ii) for which proceeds of the issue qualify. This revenue procedure does not apply to determine whether an issue of tax or revenue anticipation bonds meets the other requirements of section 148.

SECTION 5. ADVANCE RULINGS

The Service will consider requests for rulings on proposed issues of tax or revenue anticipation bonds that do not satisfy the safe harbor provided in section 4.

SECTION 6. EFFECTIVE DATE

This revenue procedure applies to tax or revenue anticipation bonds sold after May 13, 2002.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Rose M. Weber and Timothy L. Jones of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in the development of this revenue procedure. For further information regarding this revenue procedure, contact Rose M. Weber or Timothy L. Jones at (202) 622–3980 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Required Distributions From Retirement Plans

REG–108697–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In the Rules and Regulations section of the **Federal Register**, the IRS is issuing temporary regulations (T.D. 8987 on page 852 of this Bulletin) that provide guidance concerning required minimum distributions for defined benefit plans and annuity contracts providing benefits under qualified plans, individual retirement plans, and section 403(b) contracts. The regulations will provide the public with guidance necessary to comply with the law and will affect administrators of, participants in, and beneficiaries of qualified plans; institutions that sponsor and individuals who administer individual retirement plans, individuals who use individual retirement plans for retirement income, and beneficiaries of individual retirement plans; and employees for whom amounts are contributed to section 403(b) annuity contracts, custodial accounts, or retirement income accounts and beneficiaries of such contracts and accounts. The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments must be received by July 16, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–108697–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–108697–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *http://www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Cathy Vohs at 622–6090

SUPPLEMENTARY INFORMATION:

Background

Final and Temporary regulations in the Rules and Regulations portion of the Federal Register amend the Income Tax Regulations (26 CFR part 1) relating to section 401(a)(9). The temporary regulations (§ 1.401(a)(9)–6T) contain rules relating to minimum distribution requirements for defined benefit plans and annuity contracts purchased with an employee's account balance under a defined contribution plan. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because § 1.401(a)(9)–6 imposes no new collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Marjorie Hoffman and Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 1.401(a)(9)–6 is also issued under 26 U.S.C. 401(a)(9). * * *

Par. 2. Section 1.401(a)(9)–6 is added to read as follows:

§ 1.401(a)(9)–6 Required minimum distributions from defined benefit plans.

[The text of proposed § 1.401(a)(9)–6 is the same as the text of § 1.401(a)(9)–6T published elsewhere in this issue of the **Federal Register**].

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 16, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 17, 2002, 67 F.R. 18834)

Extended Period for Use of Certain Forms

Announcement 2002–49

In Rev. Proc. 2002–10 (2002–4 I.R.B. 401), the Service provided that existing model IRAs, SEPs, and SIMPLE IRA plans may not be used after June 1, 2002, to establish new IRAs, SEPs, or SIMPLE IRA plans. In response to comments, the Service is extending the June 1 deadline to October 1, 2002. Thus, a financial institution may use an existing model IRA to establish a new IRA for a customer through October 1, 2002. Similarly, an employer may use an existing model SEP or SIMPLE IRA plan to establish such a plan through October 1, 2002. The deadlines by which revised model forms must be adopted under Rev. Proc. 2002–10 are unchanged.

Filing of Form 8851, *Summary of Archer MSAs*, Extended to Calendar Year 2002

Announcement 2002–52

General

As a result of the Job Creation and Worker Assistance Act of 2002, Public Law 107–147, the filing of Form 8851, *Summary of Archer MSAs*, was extended into calendar year 2002.

01. The most current electronic/magnetic filing procedures are found in Revenue Procedure 2001–31, printed in Internal Revenue Bulletin 2001–20, dated May 14, 2001.

02. The due date for filing paper returns with IRS also applies to electronic and magnetic media filing. File Form 8851, postmarked no later than August 1, 2002, to report the number of Archer MSAs you established from January 1 through June 30, 2002.

03. All correspondence, paper forms and media relating to Form 8851 should be sent to:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: 8851 Coordinator
240 Murall Drive
Kearneysville, WV 25430

.04 A list of the acceptable media and methods of filing Form 8851 are as follows:

- Electronic Filing — FIRE System
- Magnetic Tape
- Tape Cartridge
- 8mm, 4mm, and Quarter Inch Cartridges (QIC)
- 3 ½-Inch Diskette

☞ **Note: Beginning in January 2003, IRS/MCC will no longer accept 9–track magnetic tape for the filing of Form 8851. Beginning in January 2004, 8mm, 4mm, or Quarter Inch Cartridges (QIC) will no longer be acceptable**.

.05 The Information Reporting Program (IRP) Call Site was reorganized and is now the IRP Customer Service Section. The IRP Customer Service Section continues to assist filers via a toll-free number and e-mail with information return issues. **The new toll-free number is 866–455–7438**. The toll-free number can only be used within the United States. Filers may continue to use the original telephone number, 304–263–8700 or TTY/TDD 304–267–3367 (not toll-free). E-mail may be sent to *mccirp@irs.gov*. Hours of operation are Monday through Friday, 8:30 a.m. to 4:30 p.m., Eastern time.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

Bulletins 2002–1 through 2002–18

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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*U.S. Government Printing Office: 2002— 491-341/60028

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Internal Revenue
bulletin

Bulletin No. 2002–20
May 20, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Ct. D. 2074, page 954.
Lookback period. The Supreme Court has concluded that under sections 6501, 6322, and 6323 of the Code, the lookback period is tolled during the pendency of a prior bankruptcy petition. **Young, et ux., v. United States**.

Rev. Rul. 2002–27, page 925.
Cafeteria plans. Cafeteria plans may use an automatic enrollment process whereby the employee's salary is reduced each year to pay for a portion of the group health coverage under the plan unless the employee affirmatively elects cash. In addition, employers may treat all participants as being in the cafeteria plan for section 415 purposes even though the plan mandates salary reduction and coverage for uninsured participants.

Rev. Rul. 2002–29, page 940.
LIFO; price indexes; department stores. The March 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, March 31, 2002.

T.D. 8988, page 929.
REG–163892–01, page 968.
Temporary and proposed regulations under section 355(e) of the Code relate to the recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. These regulations provide guidance on whether an acquisition is part of a plan that includes the distribution. The proposed regulations withdraw REG–107566–00 (2001–1 C.B. 346).

T.D. 8989, page 920.
REG–107184–00, page 967.
Final, temporary, and proposed regulations are designed to eliminate regulatory impediments to the electronic filing of Form 1040, *U.S. Individual Income Tax Return*.

T.D. 8990, page 947.
Final regulations under section 1092 of the Code provide rules under which equity options with flexible terms and certain qualifying over-the-counter options may, under certain conditions, be eligible for qualified covered call treatment. This regulation also provides a maximum term limitation of 33 months for certain qualified covered calls.

Rev. Proc. 2002–32, page 959.
Waiver of 60-month bar on reconsolidation after disaffiliation. This procedure provides guidance to certain taxpayers in obtaining a waiver of the general rule of section 1504(a)(3)(A) of the Code barring a corporation from filing a consolidated return with a group of which it had ceased to be a member for 60 months following the year of disaffiliation. Rev. Proc. 91–71 clarified and superseded.

EMPLOYEE PLANS

Rev. Rul. 2002–27, page 925.
Cafeteria plans. Cafeteria plans may use an automatic enrollment process whereby the employee's salary is reduced each year to pay for a portion of the group health coverage under the plan unless the employee affirmatively elects cash. In addition, employers may treat all participants as being in the cafeteria plan for section 415 purposes even though the plan mandates salary reduction and coverage for uninsured participants.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

Rev. Rul. 2002–28, page 941.
Private foundation transfer of assets; notification, filing, and other implications. This ruling addresses a private foundation's responsibilities relating to sections 507 and 4940 through 4945 of the Code and its tax return filing obligations in sections 6033 and 6043 when it transfers all of its assets to one or more effectively controlled private foundations.

ADMINISTRATIVE

Rev. Proc. 2002–33, page 963.
Additional first year depreciation. This procedure provides ways for taxpayers to claim the additional first year depreciation and other deductions for qualified property or qualified New York Liberty Zone (Liberty Zone) property that the taxpayers did not claim on their federal tax returns filed before June 1, 2002. This procedure also explains how taxpayers may elect not to deduct the additional first year depreciation for qualified property and Liberty Zone property. Rev. Proc. 2002–9 modified and amplified.

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Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 48.—Energy Credit; Reforestation Credit

26 CFR 1.48–12: Qualified rehabilitated building; expenditures incurred after December 31, 1981.

T.D. 8989

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301 and 602

Guidance Necessary to Facilitate Electronic Tax Administration

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations designed to eliminate regulatory impediments to the electronic filing of Form 1040, *U.S. Individual Income Tax Return*. These regulations generally affect taxpayers who file Form 1040 electronically and who are required to file any of the following forms: Form 56, *Notice Concerning Fiduciary Relationship*; Form 2120, *Multiple Support Declaration*; Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*; Form 3468, *Investment Credit*; and Form T (Timber), *Forest Activities Schedules*. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in REG–107184–00 on page 968 of this issue of the Bulletin.

EFFECTIVE DATE: These regulations are effective April 24, 2002.

FOR FURTHER INFORMATION CONTACT: James C. Gibbons, (202) 622–4910 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collections of information contained in these regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1783. Responses to these collections of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

For further information concerning these collections of information, and where to submit comments on the collections of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) and the Procedure and Administration Regulations (26 CFR part 301) designed to eliminate regulatory impediments to the electronic filing of Form 1040.

In 1998, Congress enacted the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 1998), Public Law 105–206 (112 Stat. 685) (1998). Section 2001(a) of RRA 1998 states that the policy of Congress is that paperless filing should be the preferred and most convenient means of filing Federal tax returns. Section 2001(a) of RRA 1998 also sets a long-range goal for the IRS to have at least 80 percent of all Federal tax returns filed electronically by 2007. Section 2001(b) of RRA 1998 requires the IRS to establish a 10-year strategic plan to eliminate barriers to electronic filing. To the extent practicable, this plan is to provide for electronic filing of electronically prepared returns for taxable years beginning after 2001.

The temporary regulations amend the Procedure and Administration Regulations to provide a regulatory statement of IRS authority to prescribe what return information or documentation must be filed with a return, statement or other document required to be made under any provision of the internal revenue laws or regulations. The regulations give the IRS maximum flexibility in prescribing (1) what needs to be filed in support of a return or claim, and (2) the form of the filing, *e.g.*, electronic versus paper. The regulations permit the IRS to prescribe required return information in forms, instructions, or other appropriate guidance.

In addition, the IRS identified five regulatory provisions that impede electronic filing by requiring the taxpayer to either include a third-party signature, or attach a document generated by a third party. The temporary regulations amend those provisions to eliminate the impediments.

Although the regulatory impediments to the electronic filing of Form 1040 are eliminated by the temporary regulations, the IRS may instruct a taxpayer who files Form 1040 on paper to attach a document that would not be required in the case of a Form 1040 filed electronically.

Explanation of Provisions

1. *General Provision*

Section 6001(a) of the Internal Revenue Code (Code) provides that every person liable for any tax, or for the collection thereof, will keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. The Secretary may require any person, by notice served upon such person or by regulations, to make

such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax.

Section 6011(a) of the Code provides that any person liable for any tax, or for the collection thereof, will make a return or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return or statement shall include therein the information required by such forms and regulations.

The temporary regulations amend the general provisions under § 301.6011–1 of the Procedure and Administration Regulations to provide a regulatory statement of the Secretary's authority to prescribe in forms, instructions, or other appropriate guidance what information or documentation must be filed with any return or statement required to be made or other document required to be furnished under any provision of the internal revenue laws or regulations. Under this authority, the IRS may change forms and instructions to eliminate nonstatutory impediments, such as third-party signature or document requirements, to the electronic filing of Form 1040.

2. *FORM T (TIMBER): Forest Activities Schedules*

Section 611 of the Code generally provides a reasonable allowance for depletion and for depreciation of improvements in computing taxable income from timber. See §§ 1.611–1(a) and 1.611–5(a) of the Income Tax Regulations. Section 1.611–3(h) provides that a taxpayer claiming a deduction for depletion of timber or for depreciation of plant and other improvements must attach to the taxpayer's income tax return a filled-out Form T for the taxable year covered by the income tax return. This section specifically provides that the information required by Form T will include a map, where necessary, to show clearly timber and land acquired, timber cut, and timber and land sold.

The attachment of a map to Form T is a regulatory impediment to the electronic filing of Form 1040 because it is a diagram not easily incorporated into an electronic return. It is also often generated by a third party. To enable the electronic filing of Form T, the temporary regulations remove the requirement that a taxpayer attach a map to substantiate the claimed depletion and depreciation. Instead, the temporary regulations require the taxpayer to be prepared to furnish a map, where necessary, to substantiate any claimed depletion or depreciation.

3. *FORM 56: Notice Concerning Fiduciary Relationship*

Section 6903(b) of the Code requires a fiduciary to give notice of his or her qualification as a fiduciary to the IRS in accordance with regulations prescribed by the Secretary. Section 301.6903–1(b) of the Procedure and Administration Regulations provides that satisfactory evidence of the authority of the fiduciary to act for any other person in a fiduciary capacity must be filed with and made a part of the notice. Form 56, the notice concerning fiduciary relationship, requires a fiduciary to attach a certified copy of the document creating the fiduciary relationship. The attachment of evidence of fiduciary relationship is a regulatory impediment to the electronic filing of Form 56 because the evidence is a document generated by a third party.

To eliminate the barrier to electronic filing, Form 56 should be filed separately from Form 1040. Further, to enable the electronic filing of Form 56, the temporary regulations remove the requirement that the fiduciary attach the evidence of fiduciary relationship to Form 56. Instead, the temporary regulations require the fiduciary to be prepared to furnish the evidence to substantiate the fiduciary relationship.

4. *FORM 2120: Multiple Support Declaration*

Section 152(c) of the Code provides that a taxpayer will be treated as having contributed over half of the support of an individual for a calendar year if: (1) no one person contributed over half of the individual's support; (2) each person in the group that collectively contributed more than half of the support of the individual would have been entitled to claim the individual as a dependent but for the fact that the person did not contribute over half of the individual's support; (3) the taxpayer claiming the individual as a dependent contributed more than 10 percent of the individual's support; and (4) every other person in the group who contributed more than 10 percent of the support files a written declaration that the person will not claim the individual as a dependent for any taxable year beginning in such calendar year. Section 1.152–3(a)(4) and (c) of the Income Tax Regulations requires that a taxpayer claiming an individual as a dependent attach to the taxpayer's income tax return a written declaration of waiver signed by the other persons described in section 152(c)(2). Form 2120 is used to make these waiver declarations.

Attaching the Form 2120 with third-party waiver declarations to Form 1040 is a regulatory impediment to the electronic filing of Form 1040 because third-party signatures are not easily incorporated into an electronic return. Therefore, the temporary regulations eliminate the requirement to attach the waiver declarations. Under the temporary regulations, a taxpayer claiming an individual as a dependent under a multiple support agreement is still required to obtain the waiver declarations but is no longer required to attach them to the taxpayer's income tax return. Instead, the temporary regulations require the taxpayer to attach a statement that (1) identifies the other persons described in section 152(c)(2) and (2) indicates that the taxpayer obtained waiver declarations from these persons. The temporary regulations will also require the taxpayer to retain the waiver declarations.

5. *FORM 2439: Notice to Shareholder of Undistributed Long-Term Capital Gains*

Under § 1.852–4(b)(2) of the Income Tax Regulations, a person who is a shareholder of a regulated investment company at the close of the company's taxable year must include undistributed capital gain in long-term capital gain. Section 1.852–9(a)(1) requires the regulated investment company to give its shareholders notice of a designation of undistributed capital gains. The regulations provide that mailed copies of Form 2439 (copies B and C) constitute appropriate notice to shareholders. Section 1.852–9(c) requires the shareholder to attach copy B of Form 2439 to the shareholder's return for the taxable year in which the undistributed capital gain is includible in gross income.

Attaching copy B of Form 2439 to the shareholder's income tax return prevents electronic filing of Form 1040 because copy B is a document generated by a third party. Therefore, the temporary regulations remove the requirement that the shareholder attach a copy of Form 2439 to Form 1040 but require that the shareholder retain a copy of Form 2439.

A shareholder who files Form 1040 electronically will supply information from the shareholder's copy of the Form 2439. However, a shareholder who files Form 1040 on paper will continue to attach a copy of Form 2439 to the shareholder's paper Form 1040 in accordance with Form 2439 instructions.

6. *FORM 3468: Investment Credit*

Section 47 of the Code generally provides a credit for rehabilitation expenditures incurred for a qualified rehabilitated building or a certified historic structure. Section 1.48–12(d)(7)(i) of the Income Tax Regulations provides that a taxpayer claiming the credit for rehabilitation of a certified historic structure must file Form 3468 with Form 1040. Form 3468 requires a copy of the final certification of completed work issued by the Secretary of the Interior. In addition, for returns filed after January 9, 1989, the taxpayer must submit evidence that the building is a certified historic structure. This status is evidenced by the final certification of completed work issued by the Secretary of the Interior. If the Secretary of the Interior has not issued a certification at the time the tax return is filed, § 1.48–12(d)(7)(ii) provides that the taxpayer must attach (1) a copy of the first page of the certification application, with an indication that it has been received by the Secretary of the Interior or designate, and (2) proof that the building is a certified historic structure (or that such status has been requested). In addition, the taxpayer is required to submit a copy of the certification as an attachment to Form 3468 accompanying the first income tax return filed after certification.

Attaching the certification impedes electronic filing of Form 3468 because it is a document generated by a third party. Therefore, the temporary regulations revise § 1.48–12(d)(7) to eliminate this requirement. For a return filed for a taxable year beginning after December 31, 2001, the taxpayer is required to provide on Form 3468 the NPS project number assigned by, and the date of the final certification of completed work received from, the Secretary of the Interior. For a taxpayer who has not received certification by the time the income tax return is filed for a year in which the credit is claimed, the current rules applicable to returns filed before receipt of the certification remain unchanged. However, the temporary regulations eliminate the requirement that the certification be attached to the first income tax return filed after its receipt. Instead, the taxpayer is required to provide the NPS project number assigned by, and the date of the final certification of completed work received from, the Secretary of the Interior on Form 3468 accompanying the first income tax return filed after certification.

Every taxpayer claiming the credit for rehabilitation of a certified historic structure must provide the required information on Form 3468 (or its successor) filed with the taxpayer's return and retain a copy of the certification. For a building owned by a pass-through entity (*i.e.*, a partnership, S corporation, estate, or trust), only the pass-through entity, not the partner, shareholder or beneficiary, must provide on Form 3468 the NPS project number assigned by, and the date of the final certification of completed work received from, the Secretary of the Interior. However, each partner, shareholder, or beneficiary claiming a credit for qualified rehabilitation expenditures from a pass-through entity must provide the employer identification number of that entity on Form 3468 (or its successor).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the persons responsible for recordkeeping are principally individuals, and the burden is not significant as described earlier in the preamble. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Sara Paige Shepherd, Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301 and 602 are amended as follows:

PART 1—INCOME TAXES

Par. 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.48–12, paragraph (d)(7)(iii) is added to read as follows:

§ 1.48–12 Qualified rehabilitated building; expenditures incurred after December 31, 1981.

* * * * *

(d) * * *

(7) * * *

(iii) *Effective dates.* Paragraph (d)(7)(i) of this section applies to returns for taxable years beginning before January 1, 2002. The requirement in the fourth sentence of paragraph (d)(7)(ii) of this section applies only if the first income tax return filed after receipt by the taxpayer of the certification is for a taxable year beginning before January 1, 2002. For rules applicable to returns for taxable years beginning after December 31, 2001, see § 1.48–12T(d)(7)(iii).

Par. 3. Section 1.48–12T is revised to read as follows:

§ 1.48–12T Qualified rehabilitated building; expenditures incurred after December 31, 1981 (temporary).

(a) through (d)(7)(ii) [Reserved] For further guidance, see § 1.48–12(a) through (d)(7)(ii).

(iii) *Returns for taxable years beginning after December 31, 2001*—(A) *In general.* Except as otherwise provided in § 1.48–12(d)(7)(ii) and this paragraph (d)(7)(iii), a taxpayer claiming the credit for rehabilitation of a certified historic structure (within the meaning of section 47(c)(3) and § 1.48–12(d)(1)) for a taxable year beginning after December 31, 2001, must provide with the return for the taxable year in which the credit is claimed, the NPS project number assigned by, and the date of the final certification of completed work received from, the Secretary of the Interior. If a credit (including a credit for a taxable year beginning before January 1, 2002) is claimed under the late certification procedures of § 1.48–12(d)(7)(ii) and the first income tax return filed by the taxpayer after receipt of the certification is for a taxable year beginning after December 31, 2001, the taxpayer must provide the NPS project number assigned by, and the date of the final certification of completed work received from, the Secretary of the Interior with that return.

(B) *Reporting and recordkeeping requirements.* The information required under paragraph (d)(7)(iii)(A) of this section must be provided on Form 3468 (or its successor) filed with the taxpayer's return. In addition, the taxpayer must retain a copy of the final certification of completed work for as long as its contents may become material in the administration of any internal revenue law.

(C) *Passthrough entities.* In the case of a credit for qualified rehabilitation expenditures of a partnership, S corporation, estate, or trust, the requirements of this paragraph (d)(7)(iii) apply only to the entity. Each partner, shareholder or beneficiary claiming a credit for such qualified rehabilitation expenditures from a passthrough entity must, however, provide the employer identification number of the entity on Form 3468 (or its successor).

(D) *Effective dates.* This paragraph (d)(7)(iii) applies to returns and records for taxable years beginning after December 31, 2001. For rules applicable to returns and records for taxable years beginning before January 1, 2002, see § 1.48–12(d)(7)(i) and the fourth sentence of § 1.48–12(d)(7)(ii).

(e) through (f)(3) [Reserved] For further guidance, see § 1.48–12(e) through (f)(3).

§ 1.152–3 [Amended]

Par. 4. In § 1.152–3, paragraph (c) is removed and reserved.

Par. 5. Section 1.152–3T is added to read as follows:

§ 1.152–3T Multiple support agreements (temporary).

(a) through (b) [Reserved] For further guidance, see § 1.152–3(a) and (b).

(c) (1) The member of a group of contributors who claims an individual as a dependent for a taxable year beginning before January 1, 2002, under the multiple support agreement provisions of section 152(c) must attach to the member's income tax return for the year of the deduction a written declaration from each of the other persons who contributed more than 10 percent of the support of such individual and who, but for the failure to contribute more than half of the support of the individual, would have been entitled to claim the individual as a dependent.

(2) The taxpayer claiming an individual as a dependent for a taxable year beginning after December 31, 2001, under the multiple support agreement provisions of section 152(c) must provide with the income tax return for the year of the deduction—

(i) A statement identifying each of the other persons who contributed more than 10 percent of the support of the individual and who, but for the failure to contribute more than half of the support of the individual, would have been entitled to claim the individual as a dependent; and

(ii) A statement indicating that the taxpayer obtained a written declaration from each of the persons described in section 152(c)(2) waiving the right to claim the individual as a dependent.

(3) The taxpayer claiming the individual as a dependent for a taxable year beginning after December 31, 2001, must retain the waiver declarations and should be prepared to furnish the waiver declarations and any other information necessary to substantiate the claim of the taxpayer. Other information that will substantiate the dependency claim of the taxpayer may include a statement showing the names of all contributors (whether or not members of the group described in section 152(c)(2)) and the amount contributed by each to the support of the claimed dependent.

§ 1.611–3 [Amended]

Par. 6. In § 1.611–3, paragraph (h) is removed and reserved.

Par. 7. Section 1.611–3T is added to read as follows:

§ 1.611–3T Rules applicable to timber (temporary).

(a) through (g) [Reserved] For further guidance, see § 1.611–3(a) through (g).

(h) *Reporting and recordkeeping requirements*—(1) *Taxable years beginning before January 1, 2002.* A taxpayer claiming a deduction for depletion of timber for a taxable year beginning before January 1, 2002, shall attach to the income tax return of the taxpayer a filled-out Form T (Timber) for the taxable year covered by the income tax return, including the following information—

(i) A map where necessary to show clearly timber and land acquired, timber cut, and timber and land sold;

(ii) Description of, cost of, and terms of purchase of timberland or timber, or cutting rights, including timber or timber rights acquired under any type of contract;

(iii) Profit or loss from sale of land, or timber, or both;

(iv) Description of timber with respect to which claim for loss, if any, is made;

(v) Record of timber cut;

(vi) Changes in each timber account as a result of purchase, sale, cutting, reestimate, or loss;

(vii) Changes in improvements accounts as the result of additions to or deductions from capital and depreciation, and computation of profit or loss on sale or other disposition of such improvements;

(viii) Operation data with respect to raw and finished material handled and inventoried;

(ix) Statement as to application of the election under section 631(a) and pertinent information in support of the fair market value claimed thereunder;

(x) Information with respect to land ownership and capital investment in timberland; and

(xi) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

(2) *Taxable years beginning after December 31, 2001.* A taxpayer claiming a deduction for depletion of timber on a return filed for a taxable year beginning after December 31, 2001, shall attach to the income tax return of the taxpayer a filled-out Form T (Timber) for the taxable year covered by the income tax return. In addition, the taxpayer must retain records sufficient to substantiate the right of the taxpayer to claim the deduction, including a map, where necessary, to show clearly timber and land acquired, timber cut, and timber and land sold for as long as their contents may become material in the administration of any internal revenue law.

§ 1.852–9 [Amended]

Par. 8. In § 1.852–9, paragraph (c)(1) is removed and reserved.

Par. 9. Section 1.852–9T is added to read as follows:

§ 1.852–9T Special procedural requirements applicable to designation under section 852(b)(3)(D) (temporary).

(a) through (b)(3) [Reserved] For further guidance, see § 1.852–9(a) through (b)(3).

(c) *Shareholders*—(1)(i) *Return requirements for taxable years beginning before January 1, 2002.* For taxable years beginning before January 1, 2002, the copy B of Form 2439 furnished to a shareholder by the regulated investment company or by a nominee, as provided in § 1.852–9(a) or (b) shall be attached to the income tax return of the shareholder for the taxable year in which the amount of undistributed capital gains is includible in gross income as provided in § 1.852–4(b)(2).

(ii) *Recordkeeping requirements for taxable years beginning after December 31, 2001.* For taxable years beginning after December 31, 2001, the shareholder shall retain a copy of Form 2439 for as long as its contents may become material in the administration of any internal revenue law.

(c)(2) through (d) [Reserved] For further guidance, see § 1.852–9(c)(2) through (d).

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 10. The authority citation for part 301 continues to read as follows:

Authority: 26 U.S.C. 7805 * * *

§ 301.6011–1 [Removed]

Par. 11. Section 301.6011–1 is removed.

Par. 12. Section 301.6011–1T is added to read as follows:

§ 301.6011–1T General requirement of return, statement or list (temporary).

(a) For provisions requiring returns, statements, or lists, see the regulations relating to the particular tax.

(b) The Secretary may prescribe in forms, instructions, or other appropriate guidance the information or documentation required to be included with any return or any statement required to be made or other document required to be furnished under any provision of the internal revenue laws or regulations.

§ 301.6903–1 [Amended]

Par. 13. In § 301.6903–1, paragraph (b) is removed and reserved.

Par. 14 Section 301.6903–1T is added to read as follows:

§ 301.6903–1T Notice of fiduciary (temporary).

(a) [Reserved] For further guidance, see § 301.6903–1(a).

(b) *Manner of notice*—(1) *Notices filed before April 24, 2002.* This paragraph (b)(1) applies to notices filed before April 24, 2002. The notice shall be signed by the fiduciary, and shall be filed with the Internal Revenue Service office where the return of the person for whom the fiduciary is acting is required to be filed. The notice must state the name and address of the person for whom the fiduciary is acting, and the nature of the liability of such person; that is, whether it is a liability for tax, and, if so, the type of tax, the year or years involved, or a liability at law or in equity of a transferee of property of a taxpayer, or a liability of a fiduciary under section 3467 of the Revised Statutes, as amended (31 U.S.C. 192) in respect of the payment of any tax from the estate of the taxpayer. Satisfactory evidence of the authority of the fiduciary to act for any other person in a fiduciary capacity must be filed with and made a part of the notice. If the fiduciary capacity exists by order of court, a certified copy of the order may be regarded as satisfactory evidence. When the fiduciary capacity has terminated, the fiduciary, in order to be relieved of any further duty or liability as such, must file with the Internal Revenue Service office with whom the notice of fiduciary relationship was filed written notice that the fiduciary capacity has terminated as to him, accompanied by satisfactory evidence of the termination of the fiduciary capacity. The notice of termination should state the name and address of the person, if any, who has been substituted as fiduciary. Any written notice disclosing a fiduciary relationship which has been filed with the Commissioner under the Internal Revenue Code of 1939 or any prior revenue law shall be considered as sufficient notice within the meaning of section 6903. Any satisfactory evidence of the authority of the fiduciary to act for another person already filed with the Commissioner or district director need not be resubmitted.

(2) *Notices filed on or after April 24, 2002.* This paragraph (b)(2) applies to notices filed on or after April 24, 2002. The notice shall be signed by the fiduciary, and shall be filed with the Internal Revenue Service Center where the return of the person for whom the fiduciary is acting is required to be filed. The notice must state the name and address of the person for whom the fiduciary is acting, and the nature of the liability of such person; that is, whether it is a liability for tax, and if so, the type of tax, the year or years involved, or a liability at law or in equity of a transferee of property of a taxpayer, or a liability of a fiduciary under 31 U.S.C. 3713(b), in respect of the payment of any tax from the estate of the

taxpayer. The fiduciary must retain satisfactory evidence of his or her authority to act for any other person in a fiduciary capacity as long as the evidence may become material in the administration of any internal revenue law.

(c) through (e) [Reserved] For further guidance, see § 301.6903–1(c) through (e).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 15. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 16. In § 602.101, paragraph (b) is amended by adding the following entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.48–12T	1545–0155
	1545–1783
* * * * *	
1.152–3T	1545–0071
	1545–1783
* * * * *	
1.611–3T	1545–0007
	1545–0099
	1545–1784
* * * * *	
1.852–9T	1545–0074
	1545–0123
	1545–0144
	1545–0145
	1545–1783
* * * * *	
301.6903–1T	1545–0013
	1545–1783
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved March 22, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on April 23, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 24, 2002, 67 F.R. 20028)

Section 56.—Adjustments in Computing Alternative Minimum Taxable Income

In determining the alternative minimum taxable income, is there an adjustment under § 56 of the Internal Revenue Code for the additional first year depreciation deduction, and the depreciation deduction otherwise allowable, for qualified property or qualified New York Liberty Zone property? See Rev. Proc. 2002–33, page 963.

Section 125.— Cafeteria Plans

(Also § 106, § 415.)

Cafeteria plans. Cafeteria plans may use an automatic enrollment process whereby the employee's salary is reduced each year to pay for a portion of the group health coverage under the plan unless the employee affirmatively elects cash. In addition, employers may treat all participants as being in the cafeteria plan for section 415 purposes even though the plan mandates salary reduction and coverage for uninsured participants.

Rev. Rul. 2002–27

ISSUES

(1) Whether employer contributions used to purchase group health coverage under § 125 of the Internal Revenue Code are included in the gross income of the employee solely because the plan uses an automatic enrollment process whereby

the employee's salary is reduced each year to pay for a portion of the coverage unless the employee affirmatively elects to receive the amount in cash.

(2) Whether an employer can treat contributions used to purchase group health coverage as compensation for purposes of § 415(c)(3) when the employee does not have the opportunity to elect cash in lieu of such contributions under a § 125 arrangement because the employee is not able to certify that he or she has other health coverage.

FACTS

Situation (1). Employer M maintains a calendar year cafeteria plan ("Plan"). The Plan offers group health insurance indemnity coverage with the option for employee-only or family coverage. The Plan is in writing and is available to all employees immediately upon hire.

The Plan provides for an automatic enrollment process. Under this Plan feature, each new employee (and each current employee for the first plan year the automatic enrollment process is effective) is automatically enrolled in employee-only indemnity coverage, with the employee's salary reduced pre-tax to pay for a portion of the cost of the coverage, unless the employee affirmatively elects cash. Alternatively, if the employee has a spouse or child, he or she can elect family coverage.

At the time an employee is hired, the employee receives a notice explaining the automatic enrollment process and the employee's right to decline coverage and have no salary reduction. The notice includes the salary reduction amounts for employee-only coverage and family coverage, procedures for exercising the right to decline coverage, information on the time by which an election must be made, and the period for which an election will be effective. The notice is also given to each current employee before the beginning of each subsequent plan year, except that the notice for a current employee includes a description of the employee's existing coverage, if any.

For a new hire, an election to receive cash or to have family coverage rather than employee-only coverage is effective if made when the employee is hired or within a reasonable period ending before the compensation for the first pay period is currently available. For a current employee, an election is effective if made prior to the start of each calendar year or under any other circumstances permitted under § 1.125–4 of the Income Tax Regulations. An election made for any prior year carries over to the next succeeding plan year unless changed.

Situation (2). Employer N also maintains a plan ("Plan") that offers group health insurance indemnity coverage which includes employee-only and family coverage options and has an automatic enrollment process. The automatic enrollment process is the same as that described in Situation (1), except that, under N's automatic enrollment process a new employee (and each current employee for the first calendar plan year the automatic enrollment process is effective) can affirmatively elect to receive cash, either at hire or during the annual election period under the Plan, only if the employee certifies that he or she has other health coverage. Employer N does not otherwise request or collect from employees information regarding other health coverage as part of the enrollment process. The Plan procedures relating to notice to employees and elections under this Plan are otherwise the same as those under the Plan sponsored by Employer M.

LAW AND ANALYSIS

Sections 106 and 125

In general, § 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 125(a) states that no amount will be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. Section 125(d) defines a cafeteria plan as a written plan under which all participants are employees and the participants may choose among two or more benefits consisting of cash and qualified benefits.

Section 125(f) defines qualified benefits as any benefit not includible in the gross income of the employee by reason of an express provision of Chapter 1 of the Code other than certain specified benefits that are not qualified benefits. Qualified benefits include employer-provided accident or health coverage under § 106(a).

Section 125 applies if the employee can choose between cash and qualified benefits. However, § 125 permits an employee's choice to be either in the form of an affirmative election to receive qualified benefits in lieu of cash or an affirmative election to receive cash in lieu of qualified benefits. Under Employer M's automatic enrollment process as described in Situation (1), an employee's salary is reduced pursuant to a procedure under which the employee receives a notice explaining his or her right to have group health coverage through salary reduction or to decline such coverage and receive the cash instead. After receiving the notice, the employee has an opportunity to choose between cash and a qualified benefit. Therefore, the Plan's automatic enrollment process is subject to the requirements of § 125.

The same conclusions apply to Situation (2) to the extent that an employee can elect cash. However, under Employer N's automatic enrollment process as described in Situation (2), an employee who does not have other health coverage is not given a choice between cash and a qualified benefit with respect to the employee-only option under the indemnity coverage. Rather, if the employee cannot certify that he or she has other health coverage, the pre-tax salary reduction is mandatory and the employee is automatically enrolled in the employee-only indemnity coverage. With respect to these employees, because there is no ability to elect cash instead of employee-only coverage, § 125 is not applicable to the employee-only coverage. (§ 125 is applicable, however, to these employees' elections to take family coverage instead of employee-only coverage).

Section 415

Section 415 imposes limitations on contributions and benefits under qualified retirement plans. Some of the limitations under § 415 that may apply to contributions or benefits provided on behalf of a participant are based on the participant's compensation, within the meaning of § 415(c)(3). The definition of compensation under § 415(c)(3) is also used for

purposes of a number of other plan qualification requirements (*see* § 414(s)(1)). Section 415(c)(3)(D)(ii) provides that an employee's compensation under § 415(c)(3) includes any amount that is contributed by the employer at the election of the employee and that is not includible in the gross income of the employee by reason of § 125. Section 415(c)(3)(D) is effective for years beginning after December 31, 1997.

Section 1.415–2(d) provides rules regarding acceptable definitions of compensation under § 415(c)(3). Under § 1.415–2(d)(3)(iv), amounts that receive special tax benefits, such as premiums for group-term life insurance (to the extent the premiums are not includible in gross income of the employee) are not included in compensation for purposes of § 415(c)(3). Thus, pursuant to § 1.415–2(d)(3)(iv), premiums for group health coverage are not treated as compensation for purposes of § 415(c)(3), except for amounts that are contributed by the employer at the election of the employee and that are not includible in the gross income of the employee by reason of § 125.

Section 415(j) directs the Secretary to prescribe such regulations as may be necessary to carry out the purposes of § 415. Section 1.415–2(d)(13) provides that the Commissioner may, in revenue rulings, notices, and other guidance of general applicability, provide additional definitions of compensation that are treated as satisfying § 415(c)(3).

Pursuant to § 1.415–2(d)(13), this revenue ruling provides that a definition of compensation does not fail to satisfy the requirements of § 415(c)(3) and § 1.415–2(d) merely because the definition provides that amounts that are not available to an employee in cash in lieu of group health coverage because the employee is not able to certify that he or she has other health coverage are treated as subject to § 125. Under this definition, amounts are permitted to be treated as subject to § 125 only if the employer does not otherwise request or collect information regarding the employee's other health coverage as part of the enrollment process for the health plan.

An employer may apply this rule for any plan year or limitation year beginning after December 31, 1997.

Section 401(b) and the regulations thereunder provide a remedial amendment period during which an amendment to a disqualifying provision may be made retroactively effective, under certain circumstances, to comply with the requirements of § 401(a). Section 1.401(b)–1(b) provides that a disqualifying provision includes an amendment to an existing plan that causes the plan to fail to satisfy the requirements of § 401(a). Notice 2001–42 (2001–30 I.R.B. 70) provides a remedial amendment period under Code § 401(b) ending not prior to the last day of the first plan year beginning on or after January 1, 2005, in which any needed retroactive amendment with regard to the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16, (EGTRRA), may be adopted. The availability of this remedial amendment period is conditioned on the adoption of a good faith EGTRRA plan amendment no later than the later of: (i) the end of the plan year in which the EGTRRA change in the qualification requirement is required to be, or is optionally, put into effect under the plan; or (ii) the end of the GUST[1] remedial amendment period for the plan.

HOLDINGS

(1) Under Situation (1), contributions used to purchase group health coverage under § 125 are not included in the gross income of the employee solely because the plan uses an automatic enrollment process whereby the employee's salary is reduced each year to pay for a portion of the group health coverage under the plan unless the employee affirmatively elects cash.

Under Situation (2), contributions used to purchase group health coverage under § 125 are not included in the gross income of the employee to the extent that an employee can elect cash. Section 125 does not apply to the employee-only coverage of an employee in Situation (2) who cannot certify that he or she has other health coverage and, therefore, does not have the ability to elect cash in lieu of health coverage. The lack of a choice between cash and a qualified benefit for these employees has no effect on whether the Plan satisfies the requirements for the exclusion from gross income of accident or health coverage under § 106(a).

(2) In determining compensation of employees for purposes of § 415(c)(3) under Holding (1), Situation (2) above, the employer can choose to treat "deemed § 125 compensation" as subject to § 125. For this purpose, "deemed § 125 compensation" is an excludable amount that is not available to an employee in cash in lieu of group health coverage under a § 125 arrangement because that employee is not able to certify that he or she has other health coverage. Under this definition, an amount is permitted to be treated as "deemed § 125 compensation" only if the employer does not otherwise request or collect information regarding the employee's other health coverage as part of the enrollment process for the health plan.

Pursuant to § 1.415–2(d)(13), a definition of compensation that otherwise satisfies § 415(c)(3) will not fail to satisfy § 415(c)(3) merely because it is amended to incorporate deemed § 125 compensation, as provided in this revenue ruling. A definition of compensation under § 415(c)(3) as amended to incorporate deemed § 125 compensation may also be used for purposes of other plan qualifica-

[1]The term "GUST" refers to the following:

- The Uruguay Round Agreements Act, Pub. L. 103–465;
- The Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103–353;
- The Small Business Job Protection Act of 1996, Pub. L. 104–188,
- The Taxpayer Relief Act of 1997, Pub. L. 105–34;
- The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105–206; and
- The Community Renewal Tax Relief Act of 2000, Pub. L. 106–554.

Unless § 19 of Rev. Proc. 2002–20, 2000–6 I.R.B. 553, as modified by Notice 2001–42 and Rev. Proc. 2001–55, 2001–55 I.R.B. 552, applies, the GUST remedial amendment period generally ended on February 28, 2002.

tion requirements (*e.g.*, § 414(s)). To the extent that a definition of compensation incorporates deemed § 125 compensation, it must apply uniformly to all employees with respect to whom amounts subject to § 125 are included in compensation.

This additional definition of compensation under § 415(c)(3) may be used in any plan year or limitation year beginning after December 31, 1997.

Retroactive Application—Pursuant to § 7805(b), for plan years beginning after December 31, 1997, and prior to January 1, 2002, the Service will not treat a qualified plan as having failed to satisfy the requirements of § 401(a) merely because the plan treated "deemed § 125 compensation" as compensation for purposes of § 415(c)(3), provided the plan is amended to provide the definition of "deemed § 125 compensation" on or before the end of the 2002 plan year and the amendment is effective for all years the plan operated in accordance with this definition.

Prospective Application. A plan that has not in operation been including "deemed §125 compensation" for purposes of § 415(c)(3) for plan or limitation years beginning before January 1, 2002, may not be amended retroactively, but must be amended for years beginning on or after January 1, 2002, in order for such amounts to be treated as § 415(c)(3) compensation in such years. Such amendment must be adopted no later than the end of the plan year in which it is effective.

Any plan amendment adopted in a timely manner pursuant to this revenue ruling will, if it results in a disqualifying provision, have the same remedial amendment period as the EGTRRA remedial amendment period. *See* Notice 2001–42. The Appendix provides a model plan amendment that a plan sponsor, or a sponsor of a pre-approved plan, may adopt to use the alternative definition of compensation. Adoption of the model amendment will not result in a disqualifying provision.

EFFECT ON OTHER REVENUE RULINGS

None

DRAFTING INFORMATION

The principal authors of this Revenue Ruling are Felix Zech of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Andrew Zuckerman of Employee Plans (Tax Exempt and Government Entities Division). For further information regarding this Revenue Ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Zech may be reached at 1–202–622–6080 and Mr. Zuckerman may be reached at 1–202–283–9655 (not toll-free numbers).

APPENDIX — MODEL AMENDMENT

The following is a model amendment that a sponsor of a qualified plan may choose to adopt if the sponsor maintains a health program in conjunction with a § 125 arrangement but permits an employee to elect cash in lieu of group health coverage only if the employee is able to certify that he or she has other health coverage. The use of this amendment will generally also apply to the definition of compensation for purposes of Code § 414(s) unless the plan otherwise specifically excludes all amounts described in § 414(s)(2).

A pre-approved plan (that is, a master or prototype or volume submitter plan) may be amended by the document's sponsor to use the alternative definition of compensation to the extent authorized. Alternatively, adopting employers may adopt a plan amendment as an addendum to the plan or adoption agreement. The inclusion of the model plan amendment below in an addendum to a plan adopted to comply with EGTRRA will not cause a pre-approved plan to be treated as an individually designed plan. A plan sponsor that adopts the model amendment verbatim (or with only minor changes) will have reliance that the form of its plan satisfies the requirements of this revenue ruling, and the adoption of such an amendment will not adversely affect the plan sponsor's or the adopting employer's reliance on a favorable determination, opinion or advisory letter.

1. Effective date. This section ____________ shall apply to plan years and limitation years beginning on and after [insert the later of January 1, 1998, or the first day of the first plan year the plan was operated in accordance with the definition in this section.]

2. For purposes of the definition of compensation under section(s) ____________, amounts under § 125 include any amounts not available to a participant in cash in lieu of group health coverage because the participant is unable to certify that he or she has other health coverage. An amount will be treated as an amount under § 125 only if the Employer does not request or collect information regarding the participant's other health coverage as part of the enrollment process for the health plan. [Insert in the blank section references for the plan's provisions that refer to amounts under § 125.]

Section 168.—Accelerated Cost Recovery System

How does a taxpayer elect not to deduct the additional first year depreciation provided by § 168(k) of the Internal Revenue Code for qualified property and what is the applicable depreciation method and recovery period for qualified New York Liberty Zone leasehold improvement property for purposes of § 168(a) or § 168(g)? See Rev. Proc. 2002–33, page 963.

Section 179.—Election to Expense Certain Depreciable Business Assets

What is the limitation under § 179(b)(1) of the Internal Revenue Code for § 179 property that is qualified New York Liberty Zone property? See Rev. Proc. 2002–33, page 963.

Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355–7T: Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

T.D. 8988

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. Changes to the applicable law were made by the Taxpayer Relief Act of 1997. These temporary regulations affect corporations and are necessary to provide them with guidance needed to comply with these changes. The text of these temporary regulations also serves as the text of the proposed regulations (REG–163892–01) set forth in this issue of the Bulletin.

DATES: *Effective Date*: These temporary regulations are effective April 26, 2002.

Applicability Date: These temporary regulations apply to distributions occurring after April 26, 2002. For rules applicable to distributions occurring after August 3, 2001, and on or before April 26, 2002, see § 1.355–7T as in effect prior to April 26, 2002 (see 26 CFR part 1 revised April 1, 2002). Taxpayers, however, may apply these regulations in whole, but not in part, to a distribution occurring on or before April 26, 2002.

FOR FURTHER INFORMATION CONTACT: Amber R. Cook of the Office of Associate Chief Counsel (Corporate), (202) 622–7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 355(e) of the Internal Revenue Code of 1986 provides that the stock of a controlled corporation will not be qualified property under section 355(c)(2) or 361(c)(2) if the stock is distributed as "part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation." For this purpose, a 50-percent or greater interest means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. See I.R.C. § 355(e)(4)(A) (referring to section 355(d)(4) for the definition of 50-percent or greater interest).

On January 2, 2001, the IRS and Treasury published in the **Federal Register** (REG–107566–00, 2001–1 C.B. 346 [66 F.R. 66]) a notice of proposed rulemaking (the 2001 proposed regulations) under section 355(e). The 2001 proposed regulations provide guidance concerning the interpretation of the phrase "plan (or series of related transactions)." The 2001 proposed regulations generally provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. The 2001 proposed regulations list a number of factors that tend to show that an acquisition and a distribution are part of a plan and a number of factors that tend to show that an acquisition and a distribution are not part of a plan. In addition, they set forth six safe harbors, the satisfaction of which confirms that a distribution and an acquisition are not part of a plan.

A public hearing regarding the 2001 proposed regulations was held on May 15, 2001. In addition, written comments were received. In response to comments that immediate guidance under section 355(e) was needed, on August 3, 2001, the IRS and Treasury published in the **Federal Register** (T.D. 8960, 2001–34 I.R.B. 176 [66 F.R. 40590]) the 2001 proposed regulations as temporary regulations (the original temporary regulations). The original temporary regulations were identical to the 2001 proposed regulations, except that, pending further study of the comments received regarding the 2001 proposed regulations, they reserved § 1.355–7(e)(6) (suspending the running of any time period prescribed in the 2001 proposed regulations during which there is a substantial diminution of risk of loss under the principles of section 355(d)(6)(B)) and *Example 7* of the 2001 proposed regulations (interpreting the term *similar acquisition* in the context of a situation involving multiple acquisitions).

Explanation of Provisions

The IRS and Treasury have studied the comments received regarding the 2001 proposed regulations and have concluded that it is desirable to revise various aspects of the original temporary regulations. Accordingly, the IRS and Treasury are promulgating these regulations (the revised temporary regulations) as temporary to amend the original temporary regulations. The following sections describe a number of the most significant comments and the extent to which they have been incorporated in the revised temporary regulations. Further changes to

the revised temporary regulations, however, are possible before these regulations are finalized.

A. *Facts and Circumstances Generally*

The 2001 proposed regulations identify a number of facts and circumstances that tend to show whether a distribution and an acquisition are part of a plan. While some of those facts and circumstances relating to a post-distribution acquisition focus on discussions before the distribution between the acquired corporation and the acquirer regarding the acquisition or a similar acquisition, others are unrelated to whether there were such discussions before the distribution. A number of comments suggested that the relevant facts and circumstances that evidence whether a distribution and a post-distribution acquisition are part of a plan for purposes of section 355(e) generally should focus more heavily on whether there were bilateral discussions or even an agreement, understanding, or arrangement regarding the acquisition within a certain period of time prior to the distribution.

The IRS and Treasury agree with these comments and, accordingly, have revised the 2001 proposed regulations to reflect this emphasis. In particular, the revised temporary regulations provide that, other than in the case of an acquisition involving a public offering, a distribution and a post-distribution acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution. In addition, the list of facts and circumstances in the revised temporary regulations that tend to show that a distribution and an acquisition are part of a plan has been revised to reflect this change in emphasis.

B. *Special Rules Relating to Auctions*

As set forth in the 2001 proposed regulations, the facts and circumstances tending to show whether a distribution and an acquisition are part of a plan distinguish between acquisitions other than acquisitions involving a public offering or auction, on the one hand, and acquisitions involving a public offering or auction, on the other hand. For example, while the distributing or controlled corporation's discussions with an acquirer regarding a post-distribution acquisition involving a public offering or auction are not listed as evidence that the distribution and the acquisition are part of a plan, the distributing or controlled corporation's discussions with an acquirer regarding a post-distribution acquisition not involving a public offering or auction tend to show that the distribution and the acquisition are part of a plan.

One commentator suggested that the facts that tend to indicate that a distribution and an acquisition are part of a plan should not distinguish between an acquisition (other than an acquisition involving a public offering) that results from an auction and an acquisition (other than an acquisition involving a public offering) that does not result from an auction. In particular, the commentator asserted that although the factors might be weighted differently depending on the particular type of acquisition, in the context of both of these types of acquisitions, discussions with the acquirer regarding the acquisition are relevant to the determination of whether a distribution and an acquisition are part of a plan.

The IRS and Treasury believe that it is difficult to define an auction in a manner that identifies those situations to which it is appropriate to apply the special auction rules contained in the 2001 proposed regulations. For this reason, the revised temporary regulations eliminate the distinction between acquisitions (other than acquisitions involving a public offering) that result from an auction and acquisitions (other than acquisitions involving a public offering) that do not result from an auction. Accordingly, those facts and circumstances related to negotiations with the acquirer that evidence whether a post-distribution acquisition (other than an acquisition involving a public offering) that does not result from an auction is part of a plan are relevant to whether a post-distribution acquisition that results from an auction is part of a plan.

C. *Similar Acquisition*

As described above, the 2001 proposed regulations identify a number of facts and circumstances that are relevant for purposes of determining whether a distribution and an acquisition are part of a plan. In the case of an acquisition after a distribution, certain factors focus on whether certain persons engaged in discussions regarding the acquisition or a "similar acquisition" before the distribution. The 2001 proposed regulations provide that an acquisition and an intended acquisition may be similar even though the identity of the person acquiring stock of the distributing or controlled corporation, the timing of the acquisition or the terms of the actual acquisition are different from the intended acquisition.

Example 7 of the 2001 proposed regulations interprets the term *similar acquisition* in the context of multiple acquisitions following a distribution that was motivated by an acquisition business purpose. The example treats an acquisition where neither the distributing nor the controlled corporation had identified the acquirer prior to the distribution and another acquisition where the acquirer had been identified but not contacted regarding the acquisition prior to the distribution as similar to an acquisition that was in fact discussed with the acquirer prior to the distribution and that was consummated prior to these additional acquisitions. After analyzing the facts and circumstances, the example concludes that these additional acquisitions and the distribution are part of a plan.

A number of commentators asserted that the interpretation of the term plan in the 2001 proposed regulations is overly broad, principally as a result of the illustration of the scope of the term *similar acquisition* in *Example 7*. Some of these commentators suggested that the unilateral intentions of one party should not result in a distribution and an acquisition being treated as part of a plan, unless that party has the unilateral ability to control both the distribution and the acquisition. In the context of acquisitions other than public offerings, therefore, some of these commentators argued that a distribution and an acquisition should not be treated as part of a plan unless there is some objective evidence of a bilateral agreement regarding the significant economic terms of the acquisition.

In addition, while the comments generally reflected the view that an acquisition should not avoid being treated as part of a plan merely because the terms of the

specific acquisition intended at the time of the distribution were modified, some comments suggested that the term similar acquisition should be narrowed. For example, certain comments suggested that where there is a change in acquirer and the new acquirer is not related to the originally intended acquirer under section 267(b) or 707(b), the new acquisition should not be treated as similar to the originally intended acquisition.

Consistent with the comments' suggestions, the revised temporary regulations set forth a definition of *similar acquisition* that is narrower than the one set forth in the 2001 proposed regulations. The revised temporary regulations provide, in general, that an actual acquisition (other than a public offering or other stock issuance for cash) is similar to another potential acquisition if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business operations as the combination that would have been effected by such other potential acquisition. Further clarification is provided in the definition of *similar acquisition*, *Example 6*, and *Example 7* of the revised temporary regulations. The revised definition of *similar acquisition* (and the revisions to the plan and non-plan factors) have the effect of reversing the conclusion of *Example 7* of the 2001 proposed regulations that the additional acquisitions (*i.e.*, the Y and Z acquisitions) and the distribution are part of a plan.

D. *Substantial Negotiations*

In addition to the comments regarding the general approach of the 2001 proposed regulations, the IRS and Treasury received a number of technical comments regarding the 2001 proposed regulations. A number of commentators suggested that *substantial negotiations* be defined. The revised temporary regulations add a definition of *substantial negotiations* providing that, in the case of an acquisition other than a public offering, substantial negotiations generally require discussions of significant economic terms, *e.g.*, the exchange ratio in a reorganization, by one or more officers, directors, or controlling shareholders of the distributing or controlled corporation, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of the distributing or controlled corporation, with the acquirer or a person or persons with the implicit or explicit permission of the acquirer. This definition is intended to clarify that both the content of, and persons engaging in, the discussions are probative of whether discussions are properly treated as substantial negotiations.

E. *Safe Harbors I and II*

Safe Harbors I and II of the 2001 proposed regulations provide certainty that a distribution and an acquisition occurring after the distribution will not be treated as part of a plan if, among other conditions, the acquisition occurs more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution. Safe Harbors I and II of the 2001 proposed regulations, therefore, are not available if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition at any time prior to the distribution. Commentators, however, suggested that not all pre-distribution substantial negotiations should prevent those Safe Harbors from being available. In particular, a number of commentators suggested that, even if the relevant parties engage in substantial negotiations regarding an acquisition prior to a distribution, provided that those negotiations terminate without agreement prior to the distribution and do not resume until 6 months or 1 year after the distribution, those substantial negotiations should not cause Safe Harbors I and II of the 2001 proposed regulations to be unavailable. After consideration of these comments, the IRS and Treasury have decided that an agreement, understanding, arrangement, or substantial negotiations concerning the acquisition should make Safe Harbors I and II unavailable only if such events exist or occur during the period that begins 1 year prior to the distribution and ends 6 months thereafter.

A number of commentators noted that Safe Harbors I and II of the 2001 proposed regulations would be available if there was an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition similar to another acquisition prior to the date that is 6 months after the distribution. At least one commentator suggested that these Safe Harbors should not be available in these circumstances. The IRS and Treasury agree and have modified those Safe Harbors accordingly.

Safe Harbor I of the 2001 proposed regulations states that it is only available if "[t]he distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate an acquisition of Distributing or Controlled." Commentators proposed that Safe Harbor I of the 2001 proposed regulations be modified so that in testing the qualification of an acquisition for the Safe Harbor, only acquisitive business purposes related to the acquired corporation should be relevant. Safe Harbor I of the revised temporary regulations reflects this comment.

Safe Harbor II of the 2001 proposed regulations is available only where (1) the amount of stock of the distributing corporation or the controlled corporation that is subject to an acquisition business purpose is not more than 33 percent of the distributing corporation or the controlled corporation; and (2) no more than 20 percent of the acquired corporation is acquired before a date that is 6 months after the distribution. Commentators suggested the elimination of one of the 2 prongs. Alternatively, they suggested increasing the percentage of stock in the second prong. One commentator also suggested that certain acquisitions that were not treated as part of a plan that includes a distribution be disregarded for purposes of the second prong.

To simplify Safe Harbor II of the 2001 proposed regulations, the revised temporary regulations eliminate the quantitative restriction of the first prong and increase the percentage of stock in the second prong to 25 percent. Furthermore, for purposes of the 25-percent test, only stock that is acquired or is the subject of an agreement, understanding, arrangement, or substantial negotiations at some time during the period that begins 1 year before the distribution and ends 6 months thereafter, other than stock that is acquired in a transaction described in Safe Harbor V, Safe Harbor VI, or new Safe Harbor VII, described below, of the revised temporary regulations, is counted.

F. *Safe Harbor V*

Subject to certain exceptions, Safe Harbor V of the 2001 proposed regulations provides that an acquisition of stock of the distributing or controlled corporation that is listed on an established market is not part of a plan if the acquisition occurs pursuant to a transfer between shareholders of the distributing corporation or the controlled corporation, neither of which is a 5-percent shareholder. Some commentators suggested that this Safe Harbor should be available for stock transfers between persons that do not actively participate in the management of the corporation, even if such persons are 5-percent shareholders. These commentators suggested that such acquisitions of stock are not part of a plan that includes a distribution. The IRS and Treasury generally agree that the trading activities of persons that do not actively participate in the management of the corporation should not cause an acquisition and a distribution to be treated as part of a plan. Accordingly, the revised temporary regulations extend the availability of Safe Harbor V to persons that are neither controlling shareholders nor 10-percent shareholders either immediately before or immediately after the transfer.

Finally, the IRS and Treasury have become aware of the proposed use of publicly-traded stock, the voting rights associated with which decrease upon certain transfers, in connection with acquisitions that are part of a plan that includes a distribution. Questions have been asked regarding whether acquisitions of stock that result from public trading between persons that are not 5-percent shareholders immediately before or immediately after the transfer are protected by Safe Harbor V, even where the transferee does not succeed to all of the voting rights exercisable by the transferor with respect to such stock.

Although the IRS and Treasury believe that Safe Harbor V may be available to prevent the acquisition of such stock that is listed on an established market from being treated as part of a plan, the revised temporary regulations clarify that, if Safe Harbor V applies to an acquisition of stock that is listed on an established market and that acquisition results in an indirect acquisition of voting power by a person other than the acquirer of such stock, Safe Harbor V does not prevent an acquisition of stock (with the voting power such stock represents after the acquisition to which Safe Harbor V applies) by such other person from being treated as part of a plan. New *Example 5* of the revised temporary regulations illustrates the application of Safe Harbor V of the revised temporary regulations and the plan and non-plan factors in the context of the public trading of stock, the relative voting power associated with which varies as a result of the trading.

G. *Safe Harbor VI and New Safe Harbor VII*

Safe Harbor VI of the 2001 proposed regulations generally applies to acquisitions of the stock of the distributing or controlled corporation "by an employee or director of Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A), in connection with the performance of services as an employee or director for the corporation or a person related to it under section 355(d)(7)(A)." One commentator suggested that Safe Harbor VI of the 2001 proposed regulations should be extended to stock acquired by independent contractors in connection with the performance of services and stock acquired pursuant to certain stock compensation plans. Another commentator suggested that Safe Harbor VI of the 2001 proposed regulations should not protect management leveraged buy-outs and going private transactions that are part of a plan that includes a distribution. Safe Harbor VI of the revised temporary regulations incorporates these comments and other technical comments received.

Commentators also suggested that Safe Harbor VI of the 2001 proposed regulations be extended to acquisitions of stock by qualified plans under section 401. In response to these commentators, the revised temporary regulations add new Safe Harbor VII. Subject to certain limitations, new Safe Harbor VII provides that acquisitions of stock of the distributing or controlled corporation by a retirement plan of an employer that qualifies under section 401(a) or 403(a) will not be treated as part of a plan that includes a distribution.

H. *Operating Rules*

1. *Reasonable certainty*

Under the 2001 proposed regulations, the fact that the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition of the distributing or controlled corporation tends to show that a distribution and an acquisition are part of a plan. The 2001 proposed regulations provide that evidence of a business purpose to facilitate an acquisition after a distribution exists if, at the time of the distribution, there was "reasonable certainty" that, within six months after the distribution, an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition. In addition, the 2001 proposed regulations provide that in the case of an acquisition before a distribution, if at the time of the acquisition, it was reasonably certain that before a date that is 6 months after the acquisition the distribution would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding the distribution, the reasonable certainty is evidence of a business purpose to facilitate an acquisition. The IRS and Treasury received a number of comments regarding the reasonable certainty rule. The revised temporary regulations delete the reasonable certainty operating rules in light of the emphasis in the revised temporary regulations on discussions or an agreement, understanding, arrangement, or substantial negotiations regarding the first step before the second step.

2. *Substantial diminution of risk*

The 2001 proposed regulations contain an operating rule that suspends the running of any time period prescribed in the regulations during which risk of loss is diminished under the principles of section 355(d)(6)(B). Commentators questioned the proper application of this rule. In light of these comments, as stated above, the original temporary regulations reserve as to the substantial diminution of risk rule pending IRS and Treasury consideration of its proper application. Although the revised temporary regulations have eliminated the substantial diminution of risk

rule, the IRS and Treasury continue to consider its proper application.

I. *Options*

The 2001 proposed regulations provide that under certain circumstances, the acquisition of stock upon the exercise of an option, as that term is defined in the 2001 proposed regulations, may be treated as an agreement to acquire stock on the date the option was written, unless the distributing corporation establishes that on the later of the date of the stock distribution or the writing of the option, the option was not more likely than not to be exercised. Commentators suggested that, because an option may become more likely than not to be exercised for reasons other than the distribution, the date of the distribution should not be relevant in testing for the existence of a plan. Instead, the date the option is written, transferred or modified in a manner that materially increases the likelihood of exercise should be the relevant dates for purposes of determining whether an option is properly treated as an agreement to acquire stock. The revised temporary regulations modify the rule for determining whether and when an option will be treated as an agreement, understanding, or arrangement to acquire stock in a manner consistent with these comments and certain other technical comments received.

J. *Effective Date*

The revised temporary regulations are effective for distributions occurring after April 26, 2002. A number of commentators requested that taxpayers be permitted to rely on the 2001 proposed regulations for distributions occurring after April 16, 1997. In response to these comments, the revised temporary regulations permit taxpayers to apply the revised temporary regulations in whole, but not in part, to distributions occurring after April 16, 1997, and on or before April 26, 2002.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these temporary regulations, and, because no preceding notice of proposed rulemaking is required for these temporary regulations, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Amber R. Cook. However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.355–7T also issued under 26 U.S.C. 355(e)(5). * * *

Par. 2. Section 1.355–0 is amended by revising the heading and the entry for § 1.355–7T to read as follows:

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* * * * *

§ 1.355–7T Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

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(9) Ten-percent shareholder.
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Par. 3. Section 1.355–7T is revised to read as follows:

§ 1.355–7T Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

(a) *In general.* Except as provided in section 355(e) and in this section, section 355(e) applies to any distribution—

(1) To which section 355 (or so much of section 356 as relates to section 355) applies; and

(2) That is part of a plan (or series of related transactions) (hereinafter, plan) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation (Distributing) or any controlled corporation (Controlled).

(b) *Plan*—(1) *In general.* Whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. The facts and circumstances to be considered in demonstrating whether a distribution and an acquisition are part of a plan include, but are not limited to, the facts and circumstances set forth in paragraphs (b)(3) and (4) of this section. In general, the weight to be given each of the facts and circumstances depends on the particular case. Whether a distribution and an acquisition are part of a plan does not depend on the relative number of facts and circumstances set forth in paragraph (b)(3) that evidence that a distribution and an acquisition are part of a plan as compared to the relative number of facts and circumstances set forth in paragraph (b)(4) that evidence that a distribution and an acquisition are not part of a plan.

(2) *Certain post-distribution acquisitions.* In the case of an acquisition (other than involving a public offering) after a distribution, the distribution and the acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution. In the case of an acquisition (other than involving a public offering) after a distribution, the existence of an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution tends to show that the distribution and the acquisition are part of a plan. See paragraph (b)(3)(i) of this section. However, all facts and circumstances must be considered to determine whether the distribution and the acquisition are part of a plan. For example, in the case of an acquisition (other than involving a public offering) after a distribution, if the distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled (see paragraph (b)(4)(v) of this section) and would have occurred at approximately the same time and in similar form regardless of whether the acquisition or a similar acquisition was effected (see paragraph (b)(4)(vi) of this section), the taxpayer may be able to establish that the distribution and the acquisition are not part of a plan.

(3) *Plan factors.* Among the facts and circumstances tending to show that a distribution and an acquisition are part of a plan are the following:

(i) In the case of an acquisition (other than involving a public offering) after a distribution, at some time during the 2-year period ending on the date of the distribution, there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition. The weight to be accorded this fact depends on the nature, extent, and timing of the agreement, understanding, arrangement, or substantial negotiations. The existence of an agreement, understanding, or arrangement at the time of the distribution is given substantial weight.

(ii) In the case of an acquisition involving a public offering after a distribution, at some time during the 2-year period ending on the date of the distribution, there were discussions by Distributing or Controlled with an investment banker regarding the acquisition or a similar acquisition. The weight to be accorded this fact depends on the nature, extent, and timing of the discussions.

(iii) In the case of an acquisition (other than involving a public offering) before a distribution, at some time during the 2-year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with the acquirer regarding a distribution. The weight to be accorded this fact depends on the nature, extent, and timing of the discussions. In addition, in the case of an acquisition (other than involving a public offering) before a distribution where a person other than Distributing or Controlled intends to cause a distribution and, as a result of the acquisition, can meaningfully participate in the decision regarding whether to make a distribution.

(iv) In the case of an acquisition involving a public offering before a distribution, at some time during the 2-year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with an investment banker regarding a distribution. The weight to be accorded this fact depends on the nature, extent, and timing of the discussions.

(v) In the case of an acquisition either before or after a distribution, the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition.

(4) *Non-plan factors.* Among the facts and circumstances tending to show that a distribution and an acquisition are not part of a plan are the following:

(i) In the case of an acquisition involving a public offering after a distribution, during the 2-year period ending on the date of the distribution, there were no discussions by Distributing or Controlled with an investment banker regarding the acquisition or a similar acquisition.

(ii) In the case of an acquisition after a distribution, there was an identifiable, unexpected change in market or business conditions occurring after the distribution that resulted in the acquisition that was otherwise unexpected at the time of the distribution.

(iii) In the case of an acquisition (other than involving a public offering) before a distribution, during the 2-year period ending on the date of the acquisition, there were no discussions by Distributing or Controlled with the acquirer regarding a distribution. This paragraph (b)(4)(iii) does not apply if the acquisition occurred after the date of the public announcement of the planned distribution. In addition, this paragraph (b)(4)(iii) does not apply in the case of an acquisition where a person other than Distributing or Controlled intends to cause a distribution and, as a result of the acquisition, can meaningfully

participate in the decision regarding whether to make a distribution.

(iv) In the case of an acquisition before a distribution, there was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.

(v) In the case of an acquisition either before or after a distribution, the distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition.

(vi) In the case of an acquisition either before or after a distribution, the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition.

(c) *Operating rules*. The operating rules contained in this paragraph (c) apply for all purposes of this section.

(1) *Internal discussions and discussions with outside advisors evidence of business purpose*. Internal discussions and discussions with outside advisors by or on behalf of officers or directors of Distributing or Controlled may be indicative of one or more business purposes for the distribution and the relative importance of such purposes.

(2) *Takeover defense*. If Distributing engages in discussions with a potential acquirer regarding an acquisition of Distributing or Controlled and distributes Controlled stock intending, in whole or substantial part, to decrease the likelihood of the acquisition of Distributing or Controlled by separating it from another corporation that is likely to be acquired, Distributing will be treated as having a business purpose to facilitate the acquisition of the corporation that was likely to be acquired.

(3) *Effect of distribution on trading in stock*. The fact that the distribution made all or a part of the stock of Controlled available for trading or made Distributing's or Controlled's stock trade more actively is not taken into account in determining whether the distribution and an acquisition of Distributing or Controlled stock were part of a plan.

(4) *Consequences of section 355(e) disregarded for certain purposes*. For purposes of determining the intentions of the relevant parties under this section, the consequences of the application of section 355(e), and the existence of any contractual indemnity by Controlled for tax resulting from the application of section 355(e) caused by an acquisition of Controlled, are disregarded.

(5) *Multiple acquisitions*. All acquisitions of stock of Distributing or Controlled that are considered to be part of a plan with a distribution pursuant to paragraph (b) of this section will be aggregated for purposes of the 50–percent test of paragraph (a)(2) of this section.

(d) *Safe harbors*—(1) *Safe Harbor I*. A distribution and an acquisition occurring after the distribution will not be considered part of a plan if—

(i) The distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355–2(b)), other than a business purpose to facilitate an acquisition of the acquired corporation (Distributing or Controlled); and

(ii) The acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins 1 year before the distribution and ends 6 months thereafter.

(2) *Safe Harbor II*. (i) A distribution and an acquisition occurring after the distribution will not be considered part of a plan if—

(A) The distribution was not motivated by a business purpose to facilitate the acquisition or a similar acquisition;

(B) The acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins 1 year before the distribution and ends 6 months thereafter; and

(C) No more than 25 percent of the stock of the acquired corporation (Distributing or Controlled) was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations during the period that begins 1 year before the distribution and ends 6 months thereafter.

(ii) For purposes of paragraph (d)(2)(i)(C) of this section, acquisitions of stock that are treated as not part of a plan pursuant to Safe Harbor V, Safe Harbor VI, or Safe Harbor VII are disregarded.

(3) *Safe Harbor III*. If an acquisition occurs after a distribution, there was no agreement, understanding, or arrangement concerning the acquisition or a similar acquisition at the time of the distribution, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition within 1 year after the distribution, the acquisition and the distribution will not be considered part of a plan.

(4) *Safe Harbor IV*. If a distribution occurs more than 2 years after an acquisition, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter, the acquisition and the distribution will not be considered part of a plan.

(5) *Safe Harbor V*—(i) *In general*. An acquisition of Distributing or Controlled stock that is listed on an established market is not part of a plan if, immediately before or immediately after the transfer, none of the transferor, the transferee, and any coordinating group of which either the transferor or the transferee is a member is—

(A) the acquired corporation (Distributing or Controlled);

(B) a corporation that the acquired corporation (Distributing or Controlled) controls within the meaning of section 368(c);

(C) a member of a controlled group of corporations within the meaning of section 1563 of which the acquired corporation (Distributing or Controlled) is a member;

(D) an underwriter with respect to such acquisition;

(E) a controlling shareholder of the acquired corporation (Distributing or Controlled); or

(F) a 10-percent shareholder of the acquired corporation (Distributing or Controlled).

(ii) *Special rules*. (A) This paragraph (d)(5) does not apply to a transfer of stock by or to a person if the corporation the stock of which is being transferred knows, or has reason to know, that the person or a coordinating group of which

such person is a member intends to become a controlling shareholder or a 10-percent shareholder of the acquired corporation (Distributing or Controlled) at any time after the acquisition and before the date that is 2 years after the distribution.

(B) If a transfer of stock to which this paragraph (d)(5) applies results immediately, or upon a subsequent event or the passage of time, in an indirect acquisition of voting power by a person other than the transferee, this paragraph (d)(5) does not prevent an acquisition of stock (with the voting power such stock represents after the transfer to which this paragraph (d)(5) applies) by such other person from being treated as part of a plan.

(6) *Safe Harbor VI*—(i) *In general.* If stock of Distributing or Controlled is acquired by a person in connection with such person's performance of services as an employee, director, or independent contractor for Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) in a transaction to which section 83 or section 421(a) applies, the acquisition and the distribution will not be considered part of a plan.

(ii) *Special rule.* This paragraph (d)(6) does not apply to a stock acquisition described in (d)(6)(i) if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a 10-percent shareholder of the acquired corporation (Distributing or Controlled) immediately after the acquisition.

(7) *Safe Harbor VII*—(i) *In general.* If stock of Distributing or Controlled is acquired by a retirement plan of an employer that qualifies under section 401(a) or 403(a), the acquisition and the distribution will not be considered part of a plan.

(ii) *Special rule.* This paragraph (d)(7) does not apply to stock acquisitions described in (d)(7)(i) of this section to the extent that the stock acquired pursuant to such acquisitions by all of the qualified plans of the employer described in paragraph (d)(7)(i) of this section, and any other person treated as the same employer as that described in paragraph (d)(7)(i) of this section under section 414(b), (c), (m), or (o), during the 4-year period beginning 2 years before the distribution, in the aggregate, represents 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value of shares of all classes of stock, of the acquired corporation (Distributing or Controlled).

(e) *Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests*—(1) *Treatment of options*—(i) *General rule.* For purposes of this section, if stock of Distributing or Controlled is acquired pursuant to an option, the option will be treated as an agreement, understanding, or arrangement to acquire the stock on the earliest of the following dates: the date that the option is written, if the option was more likely than not to be exercised as of such date; the date that the option is transferred, if the option was more likely than not to be exercised as of such date; and the date that the option is modified in a manner that materially increases the likelihood of exercise, if the option was more likely than not to be exercised as of such date; provided, however, if the writing, transfer, or modification had a principal purpose of avoiding section 355(e), the option will be treated as an agreement, understanding, arrangement, or substantial negotiations to acquire the stock on the date of the distribution. The determination of whether an option was more likely than not to be exercised is based on all the facts and circumstances, taking control premiums and minority and blockage discounts into account in determining the fair market value of stock underlying an option.

(ii) *Agreement, understanding, or arrangement to write an option.* If there is an agreement, understanding, or arrangement to write an option, the option will be treated as written on the date of the agreement, understanding, or arrangement.

(iii) *Substantial negotiations related to options.* If an option is treated as an agreement, understanding, or arrangement to acquire the stock on the date that the option is written, substantial negotiations to acquire the option will be treated as substantial negotiations to acquire the stock subject to such option. If an option is treated as an agreement, understanding, or arrangement to acquire the stock on the date that the option is transferred, substantial negotiations regarding the transfer of the option will be treated as substantial negotiations to acquire the stock subject to such option. If an option is treated as an agreement, understanding, or arrangement to acquire the stock on the date that the option is modified in a manner that materially increases the likelihood of exercise, substantial negotiations regarding such modifications to the option will be treated as substantial negotiations to acquire the stock subject to such option.

(2) *Instruments treated as options.* For purposes of this paragraph (e), except to the extent provided in paragraph (e)(3) of this section, call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements (including rights to cause the redemption of stock), any other instruments that provide for the right or possibility to issue, redeem, or transfer stock (including an option on an option), or any other similar interests are treated as options.

(3) *Instruments generally not treated as options.* For purposes of this paragraph (e), the following are not treated as options unless (in the case of paragraphs (e)(3)(i), (iii), and (iv) of this section) written, transferred (directly or indirectly), modified, or listed with a principal purpose of avoiding the application of section 355(e) or this section.

(i) *Escrow, pledge, or other security agreements.* An option that is part of a security arrangement in a typical lending transaction (including a purchase money loan), if the arrangement is subject to customary commercial conditions. For this purpose, a security arrangement includes, for example, an agreement for holding stock in escrow or under a pledge or other security agreement, or an option to acquire stock contingent upon a default under a loan.

(ii) *Compensatory options.* An option to acquire stock in Distributing or Controlled with customary terms and conditions provided to a person in connection with such person's performance of services as an employee, director, or independent contractor for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), provided that—

(A) The transfer of stock pursuant to such option is described in section 421(a); or

(B) The option is nontransferable within the meaning of § 1.83–3(d) and does not have a readily ascertainable fair market value as defined in § 1.83–7(b).

(iii) *Options exercisable only upon death, disability, mental incompetency, or separation from service.* Any option entered into between shareholders of a corporation (or a shareholder and the corporation) that is exercisable only upon the death, disability, or mental incompetency of the shareholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), the shareholder's separation from service.

(iv) *Rights of first refusal.* A *bona fide* right of first refusal regarding the corporation's stock with customary terms, entered into between shareholders of a corporation (or between the corporation and a shareholder).

(v) *Other enumerated instruments.* Any other instrument the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(f) *Multiple controlled corporations.* Only the stock or securities of a controlled corporation in which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest as part of a plan involving the distribution of that corporation will be treated as not qualified property under section 355(e)(1) if—

(1) The stock or securities of more than 1 controlled corporation are distributed in distributions to which section 355 (or so much of section 356 as relates to section 355) applies; and

(2) One or more persons do not acquire, directly or indirectly, stock representing a 50-percent or greater interest in Distributing pursuant to a plan involving any of those distributions.

(g) *Valuation.* Except as provided in paragraph (e)(1)(i) of this section, for purposes of section 355(e) and this section, all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(h) *Definitions*—(1) *Agreement, understanding, arrangement, or substantial negotiations.* (i) Whether an agreement, understanding, or arrangement exists depends on the facts and circumstances. The parties do not necessarily have to have entered into a binding contract or have reached agreement on all significant economic terms to have an agreement, understanding, or arrangement. However, an agreement, understanding, or arrangement clearly exists if a binding contract to acquire stock exists.

(ii) Substantial negotiations in the case of an acquisition (other than involving a public offering) generally require discussions of significant economic terms, *e.g.*, the exchange ratio in a reorganization, by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled, with the acquirer or a person or persons with the implicit or explicit permission of the acquirer.

(iii) In the case of an acquisition involving a public offering by Distributing or Controlled, the existence of an agreement, understanding, arrangement, or substantial negotiations will be based on discussions by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled, with an investment banker.

(2) *Controlled corporation.* For purposes of this section, a controlled corporation is a corporation the stock of which is distributed in a distribution to which section 355 (or so much of section 356 as relates to section 355) applies.

(3) *Controlling shareholder.* (i) A controlling shareholder of a corporation the stock of which is listed on an established market is a 5-percent shareholder who actively participates in the management or operation of the corporation. For purposes of this paragraph (h)(3)(i), a corporate director will be treated as actively participating in the management of the corporation.

(ii) A controlling shareholder of a corporation the stock of which is not listed on an established market is any person that owns, actually or constructively under the rules of section 318, stock possessing voting power representing a meaningful voice in the governance of the corporation.

(iii) For purposes of this section, a person is a controlling shareholder if that person meets the definition of controlling shareholder in this paragraph (h)(3) immediately before or immediately after the acquisition being tested.

(iv) If a distribution precedes an acquisition, Controlled's controlling shareholders immediately after the distribution and Distributing are included among Controlled's controlling shareholders at the time of the distribution.

(4) *Coordinating group.* A coordinating group includes 2 or more persons that, pursuant to a formal or informal understanding, join in one or more coordinated acquisitions or dispositions of stock of Distributing or Controlled. A principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders. A coordinating group is treated as a single shareholder for purposes of determining whether the coordinating group is treated as a controlling shareholder or a 10-percent shareholder.

(5) *Discussions.* Discussions by Distributing or Controlled generally require discussions by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled. Discussions with the acquirer generally require discussions with the acquirer or a person or persons with the implicit or explicit permission of the acquirer.

(6) *Established market.* An established market is—

(i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Act of 1934 (15 U.S.C. 78o–3); or

(iii) Any additional market that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(7) *Five-percent shareholder*. A person will be considered a 5-percent shareholder of a corporation the stock of which is listed on an established market if the person owns, actually or constructively under the rules of section 318, 5 percent or more of any class of stock of the corporation whose stock is transferred. A person is a 5-percent shareholder if the person meets the requirements described above immediately before or immediately after the transfer. All options owned by a person are treated as exercised for the purpose of determining whether such person is a 5-percent shareholder. Absent actual knowledge that a person is a 5-percent shareholder, a corporation can rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its 5-percent shareholders.

(8) *Similar acquisition*. In general, an actual acquisition (other than a public offering or other stock issuance for cash) is similar to another potential acquisition if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business operations as the combination that would have been effected by such other potential acquisition. Thus, an actual acquisition may be similar to another acquisition even if the timing or terms of the actual acquisition are different from the timing or terms of the other acquisition. For example, an actual acquisition of Distributing by shareholders of another corporation in connection with a merger of such other corporation with and into Distributing is similar to another acquisition of Distributing by merger into such other corporation or into a subsidiary of such other corporation. However, in general, an actual acquisition (other than a public offering or other stock issuance for cash) is not similar to another acquisition if the ultimate owners of the business operations with which Distributing or Controlled is combined in the actual acquisition are substantially different from the ultimate owners of the business operations with which Distributing or Controlled was to be combined in such other acquisition. In the case of a public offering or other stock issuance for cash, an actual acquisition may be similar to another acquisition, even though there are changes in the terms of the stock, the class of stock being offered, the size of the offering, the timing of the offering, the price of the stock, or the participants in the offering.

(9) *Ten-percent shareholder*. A person will be considered a 10-percent shareholder of a corporation the stock of which is listed on an established market if the person owns, actually or constructively under the rules of section 318, 10 percent or more of any class of stock of the corporation whose stock is transferred. A person will be considered a 10-percent shareholder of a corporation the stock of which is not listed on an established market if the person owns, actually or constructively under the rules of section 318, stock possessing 10 percent or more of the total voting power of the stock of the corporation whose stock is transferred or stock having a value equal to 10 percent or more of the total value of the stock of the corporation whose stock is transferred. A person is a 10-percent shareholder if the person meets the requirements described above immediately before or immediately after the transfer. All options owned by a person are treated as exercised for the purpose of determining whether such person is a 10-percent shareholder. Absent actual knowledge that a person is a 10-percent shareholder, a corporation the stock of which is listed on an established market can rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its 10-percent shareholders.

(i) [Reserved]

(j) *Examples*. The following examples illustrate paragraphs (a) through (h) of this section. Throughout these examples, assume that Distributing (D) owns all of the stock of Controlled (C). Assume further that D distributes the stock of C in a distribution to which section 355 applies and to which section 355(d) does not apply. Unless otherwise stated, assume the corporations do not have controlling shareholders. No inference should be drawn from any example concerning whether any requirements of section 355 other than those of section 355(e) are satisfied. The examples are as follows:

Example 1. Unwanted assets. (i) D is in business 1. C is in business 2. D is relatively small in its industry. D wants to combine with X, a larger corporation also engaged in business 1. X and D begin negotiating for X to acquire D, but X does not want to acquire C. To facilitate the acquisition of D by X, D agrees to distribute all the stock of C *pro rata* before the acquisition. Prior to the distribution, D and X enter into a contract for D to merge into X subject to several conditions. One month after D and X enter into the contract, D distributes C and, on the day after the distribution, D merges into X. As a result of the merger, D's former shareholders own less than 50 percent of the stock of X.

(ii) The issue is whether the distribution of C and the merger of D into X are part of a plan. No Safe Harbor applies to this acquisition. To determine whether the distribution of C and the merger of D into X are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (b) of this section.

(iii) The following tends to show that the distribution of C and the merger of D into X are part of a plan: X and D had an agreement regarding the acquisition during the 2-year period ending on the date of the distribution (paragraph (b)(3)(i) of this section), and the distribution was motivated by a business purpose to facilitate the merger (paragraph (b)(3)(v) of this section). Because the merger was agreed to at the time of the distribution, the fact described in paragraph (b)(3)(i) of this section is given substantial weight.

(iv) None of the facts and circumstances listed in paragraph (b)(4) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(v) The distribution of C and the merger of D into X are part of a plan under paragraph (b) of this section.

Example 2. Public offering. (i) D's managers, directors, and investment banker discuss the possibility of offering D stock to the public. They decide a public offering of 20 percent of D's stock with D as a stand alone corporation would be in D's best interest. One month later, to facilitate a stock offering by D of 20 percent of its stock, D distributes all the stock of C *pro rata* to D's shareholders. D issues new shares amounting to 20 percent of its stock to the public in a public offering 7 months after the distribution.

(ii) The issue is whether the distribution of C and the public offering by D are part of a plan. No Safe Harbor applies to this acquisition. Safe Harbor V, relating to public trading, does not apply to public offerings (see paragraph (d)(5)(i)(A) of this section). To determine whether the distribution of C and the public offering by D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (b) of this section.

(iii) The following tends to show that the distribution of C and the public offering by D are part of a plan: D discussed the public offering with its investment banker during the 2-year period ending on the date of the distribution (paragraph (b)(3)(ii) of this section), and the distribution was motivated by a business purpose to facilitate the public offering (paragraph (b)(3)(v) of this section).

(iv) None of the facts and circumstances listed in paragraph (b)(4) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(v) The distribution of C and the public offering by D are part of a plan under paragraph (b) of this section.

Example 3. Hot market. (i) D is a widely-held corporation the stock of which is listed on an established market. D announces a distribution of C and distributes C *pro rata* to D's shareholders. By contract, C agrees to indemnify D for any imposition of tax under section 355(e) caused by the acts of C. The distribution is motivated by a desire to improve D's access to financing at preferred customer interest rates, which will be more readily available if D separates from C. At the time of the distribution, although neither D nor C has been approached by any potential acquirer of C, it is reasonably certain that soon after the distribution either an acquisition of C will occur or there will be an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition of C. Corporation Y acquires C in a merger described in section 368(a)(2)(E) within 6 months after the distribution. The C shareholders receive less than 50 percent of the stock of Y in the exchange.

(ii) The issue is whether the distribution of C and the acquisition of C by Y are part of a plan. No Safe Harbor applies to this acquisition. Under paragraph (b)(2) of this section, because prior to the distribution neither D nor C and Y had an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition, the distribution of C by D and the acquisition of C by Y are not part of a plan under paragraph (b) of this section.

Example 4. Unexpected opportunity. (i) D, the stock of which is listed on an established market, announces that it will distribute all the stock of C *pro rata* to D's shareholders. At the time of the announcement, the distribution is motivated wholly by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate an acquisition. After the announcement but before the distribution, widely-held X becomes available as an acquisition target. There were no discussions between D or C and X before the announcement. D negotiates with and acquires X before the distribution. After the acquisition, X's former shareholders own 55 percent of D's stock. D distributes the stock of C *pro rata* within 6 months after the acquisition of X.

(ii) The issue is whether the acquisition of X by D and the distribution of C are part of a plan. No Safe Harbor applies to this acquisition. To determine whether the acquisition of X by D and the distribution of C are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (b) of this section.

(iii) Depending on whether a person other than D or C intends to cause a distribution and, as a result of the acquisition, can meaningfully participate in the decision regarding whether to cause a distribution, the fact described in (b)(3)(iii) of this section, tending to show that a distribution and an acquisition are part of a plan, may exist in this case.

(iv) Under paragraph (b)(4) of this section, D would assert that the following tends to show that the distribution of C and the acquisition of X by D are not part of a plan: the distribution was motivated by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition (paragraph (b)(4)(v) of this section), and the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition (paragraph (b)(4)(vi) of this section). That D decided to distribute C and announced that decision before it became aware of the opportunity to acquire X suggests that the distribution would have occurred at approximately the same time and in similar form regardless of D's acquisition of X or a similar acquisition. X's lack of participation in the decision to distribute C, even though the X shareholders may have been able to prevent a distribution of C, also helps establish that fact.

(v) In determining whether the distribution of C and acquisition of X by D are part of a plan, one should consider the importance of D's business purpose for the distribution in light of D's opportunity to acquire X. If D can establish that the distribution continued to be motivated by the stated business purpose, and if D would have distributed C regardless of D's acquisition of X, then D's acquisition of X and D's distribution of C are not part of a plan under paragraph (b) of this section.

Example 5. Vote shifting transaction. (i) D is in business 1. C is in business 2. D wants to combine with X, a larger corporation also engaged in business 1. The stock of X is closely held. X and D begin negotiating for D to acquire X, but the X shareholders do not want to acquire an indirect interest in C. To facilitate the acquisition of X by D, D agrees to distribute all the stock of C *pro rata* before the acquisition of X. D and X enter into a contract for X to merge into D subject to several conditions. Among those conditions is that D will amend its corporate charter to provide for 2 classes of stock: Class A and Class B. Under all circumstances, each share of Class A stock will be entitled to 10 votes in the election of each director on D's board of directors. Upon issuance, each share of Class B stock will be entitled to 10 votes in the election of each director on D's board of directors; however, a disposition of such share by its original holder will result in such share being entitled to only 1 vote, rather than 10 votes, in the election of each director. Immediately after the merger, the Class B shares will be listed on an established market. One month after D and X enter into the contract, D distributes C. Immediately after the distribution, the shareholders of D exchange their D stock for the new Class B shares. On the day after the distribution, X merges into D. In the merger, the former shareholders of X exchange their X stock for Class A shares of D. Immediately after the merger, D's historic shareholders own stock of D representing 51 percent of the total combined voting power of all classes of stock of D entitled to vote. During the 30-day period following the merger, none of the Class A shares are transferred, but a number of D's historic shareholders sell their Class B stock of D in public trading with the result that, at the end of that 30-day period, the Class A shares owned by the former X shareholders represent 52 percent of the total combined voting power of all classes of stock of D entitled to vote.

(ii) *X acquisition.* (A) The issue is whether the distribution of C and the merger of X into D are part of a plan. No Safe Harbor applies to this acquisition. To determine whether the distribution of C and the merger of X into D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (b) of this section.

(B) The following tends to show that the distribution of C and the merger of X into D are part of a plan: X and D had an agreement regarding the acquisition during the 2-year period ending on the date of the distribution (paragraph (b)(3)(i) of this section), and the distribution was motivated by a business purpose to facilitate the merger (paragraph (b)(3)(v) of this section). Because the merger was agreed to at the time of the distribution, the fact described in paragraph (b)(3)(i) of this section is given substantial weight.

(C) None of the facts and circumstances listed in paragraph (b)(4) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(D) The distribution of C and the merger of X into D are part of a plan under paragraph (b) of this section.

(iii) *Public trading of Class B shares.* (A) Assuming that each of the transferors and the transferees of the Class B stock of D in public trading is not one of the prohibited transferors or transferees listed in paragraph (d)(5)(i), Safe Harbor V will apply to the acquisitions of the Class B stock during the 30-day period following the merger such that the distribution and those acquisitions will not be treated as part of the plan. However, to the extent that those acquisitions result in an indirect acquisition of voting power by a person other than the acquirer of the transferred stock, Safe Harbor V does not prevent the acquisition of the D stock (with the voting power such stock represents after those acquisitions) by the former X shareholders from being treated as part of a plan.

(B) To the extent that the transfer of the Class B shares causes the voting power of D to shift to the Class A stock acquired by the former X shareholders, such shifted voting power will be treated as attributable to the stock acquired by the former X shareholders as part of the plan that includes the distribution and the X acquisition.

Example 6. Acquisition that is not similar. (i) D, X, and Y are each corporations the stock of which is publicly traded and widely held. Each of D, X, and Y are engaged in the manufacture and sale of trucks. C is engaged in the manufacture and sale of buses. D and X engage in substantial negotiations concerning X's acquisition of the stock of D from the D shareholders in exchange for stock of X. D and X do not reach an agreement regarding that acquisition. Three months after D and X first began negotiations regarding that acquisition, D distributes the stock of C *pro rata* to its shareholders. Three months after the distribution, Y acquires the stock of D from the D shareholders in exchange for stock of Y.

(ii) Although both X and Y engage in the manufacture and sale of trucks, X's truck business and Y's truck business are not the same business operations. Therefore, because Y's acquisition of D does not effect a combination of the same business operations as X's acquisition of D would have effected, Y's acquisition of D is not similar to X's potential acquisition of D that was the subject of earlier negotiations.

Example 7. Acquisition that is similar. (i) D is engaged in the business of writing custom software for several industries (industries 1 through 6). The software business of D related to industries 4, 5, and 6 is significant relative to the software business of D related to industries 3, 4, 5, and 6. X, an unrelated corporation, is engaged in the business of writing software and the business of manufacturing and selling hardware devices. X's business of writing software is significant relative to its total businesses. X and D engage in substantial negotiations regarding X's acquisition of D stock from the D shareholders in exchange for stock of X. Because X does not want to acquire the software businesses related to industries 1 and 2, these negotiations relate to an acquisition of D stock where D owns the software businesses related only to industries 3, 4, 5, and 6. Thereafter, D concludes that the intellectual property licenses central to the software business related to industries 1 and 2 are not transferable and that a separation of the software business related to industry 3 from the software business related to industry 2 is not desirable. One month after D begins negotiating with X, D contributes the software businesses related to industries 4, 5, and 6 to C, and distributes the stock of C *pro rata* to its shareholders. In addition, X sells its hardware businesses for cash. After the distribution, C and X negotiate for X's acquisition of the C stock from the C shareholders in exchange for X stock, and X acquires the stock of C.

(ii) Although D and C are different corporations, C does not own the custom software business related to industry 3, and X sold its hardware business prior to the acquisition of C, because X's acquisition of C involves a combination of a significant portion of the same business operations as the combination that would have been effected by the acquisition of D that was the subject of negotiations between D and X, X's acquisition of C is the same as or similar to X's potential acquisition of D that was the subject of earlier negotiations.

(k) *Effective dates*. This section applies to distributions occurring after April 26, 2002. Taxpayers, however, may apply these regulations in whole, but not in part, to a distribution occurring after April 16, 1997, and on or before April 26, 2002. For distributions occurring after August 3, 2001, and on or before April 26, 2002, with respect to which a taxpayer chooses not to apply these regulations, see § 1.355–7T as in effect prior to April 26, 2002 (see 26 CFR part 1 revised April 1, 2002).

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 15, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 23, 2002, 12:14 p.m., and published in the issue of the Federal Register for April 26, 2002, 67 F.R. 20632)

Section 446.—General Rule for Methods of Accounting

If a taxpayer changes to claiming additional first year depreciation for qualified property or qualified New York Liberty Zone property placed in service after September 10, 2001, during the taxable year beginning in 2000 or 2001, is this change a change in method of accounting under § 446(e) of the Internal Revenue Code? See Rev. Proc. 2002–33, page 963.

Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The March 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, March 31, 2002.

Rev. Rul. 2002–29

The following Department Store Inventory Price Indexes for March 2002 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46 (1986–2 C.B. 739) for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, March 31, 2002.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Mar. 2001	Mar. 2002	Percent Change from Mar. 2001 to Mar. 2002[1]
1. Piece Goods	492.1	490.6	-0.3
2. Domestics and Draperies	597.8	583.6	-2.4
3. Women's and Children's Shoes	667.2	647.4	-3.0
4. Men's Shoes	887.5	903.0	1.7
5. Infants' Wear	632.5	624.2	-1.3
6. Women's Underwear	563.5	563.7	0.0
7. Women's Hosiery	347.0	355.7	2.5
8. Women's and Girls' Accessories	560.3	563.4	0.6
9. Women's Outerwear and Girls' Wear	419.5	401.0	-4.4
10. Men's Clothing	589.2	594.6	0.9
11. Men's Furnishings	619.4	607.3	-2.0
12. Boys' Clothing and Furnishings	484.9	482.6	-0.5
13. Jewelry	939.5	905.5	-3.6
14. Notions	782.8	800.4	2.2
15. Toilet Articles and Drugs	989.4	972.7	-1.7
16. Furniture and Bedding	646.4	630.0	-2.5
17. Floor Coverings	630.7	616.3	-2.3
18. Housewares	771.7	756.2	-2.0
19. Major Appliances	225.2	223.2	-0.9
20. Radio and Television	55.5	51.1	-7.9
21. Recreation and Education[2]	90.3	87.5	-3.1
22. Home Improvements[2]	128.2	125.6	-2.0
23. Auto Accessories[2]	109.2	110.8	1.5
Groups 1 — 15: Soft Goods	604.7	591.8	-2.1
Groups 16 — 20: Durable Goods	426.0	414.6	-2.7
Groups 21 — 23: Misc. Goods[2]	99.0	97.2	-1.8
Store Total[3]	538.3	526.5	-2.2

[1] Absence of a minus sign before the percentage change in this column signifies a price increase.
[2] Indexes on a January 1986=100 base.
[3] The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7718 (not a toll-free call).

Section 507.—Private Foundation Transfers of Assets

26 CFR 1.507–1, 1.507–3, 1.507–4, 1.507–7, 1.507–8: Special rules; transferee foundations; liability in case of transfers.
(Also §§ 4940, 4941, 4942, 4943, 4944, 4945, 6033, 6043; 53.4940–1, 53.4941(a)–1, 53.4942(a)–3, 53.4943–3, 53.4944–1, 53.4945–5, and 1.6033–2, 1.6043–3(a)(1)).

Private foundation transfer of assets; notification, filing, and other implications. This ruling addresses a private foundation's responsibilities relating to sections 507 and 4940 through 4945 of the Code and its tax return filing obligations in sections 6033 and 6043 when it transfers all of its assets to one or more effectively controlled private foundations.

ISSUES

(1) If a private foundation transfers all of its assets to one or more private foundations, is the transferor foundation required to notify the Manager, Exempt Organizations Determinations, Tax Exempt and Government Entities Division (TE/GE), that it plans to terminate its private foundation status pursuant to § 507(a) of the Internal Revenue Code and pay the tax under § 507(c)?

(2) What are a private foundation's tax return filing obligations after it transfers all of its assets to one or more transferee private foundations and:

(a) terminates, or

(b) does not terminate?

(3) If a private foundation transfers all of its assets to one or more private foundations that are effectively controlled (within the meaning of the Income Tax Regulations under § 507), directly or indirectly, by the same person or persons who effectively control the transferor foundation, what are the implications under:

(a) § 4940,

(b) § 4941,

(c) § 4942,

(d) § 4943,

(e) § 4944, and

(f) § 4945?

(4) If a private foundation transfers all of its assets to one or more private foundations that are effectively controlled (within the meaning of the regulations under § 507), directly or indirectly, by the same person or persons who effectively control the transferor foundation, what are the implications for the transferor foundation's aggregate tax benefits under § 507(d)?

FACTS

In each of the following situations: (i) the transferee private foundations are effectively controlled (within the meaning of the regulations under § 507), directly or indirectly, by the same persons who effectively controlled the transferor private foundations; (ii) the private foundations have not committed either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under chapter 42; (iii) the private foundations have not terminated under § 507(a)(2) or (b)(1); (iv) prior to the transactions described below, the transferor private foundations made outstanding grants to organizations not described in § 4945(d)(4)(A), which required the transferor foundations to exercise expenditure responsibility in accordance with § 4945(h); and (v) the private foundations are not operating foundations within the meaning of § 4942(j)(3).

SITUATION 1

P is recognized as exempt from federal tax under § 501(c)(3) and is classified as a private foundation under § 509(a). *P*'s current directors have divergent charitable objectives.

X, *Y*, and *Z* are recognized as exempt from federal tax under § 501(c)(3) and are classified as private foundations under § 509(a). Pursuant to a plan of dissolution, after satisfying all of its outstanding liabilities, *P* distributes all of its remaining assets in equal shares to *X*, *Y*, and *Z*. As part of the plan of dissolution, *X* agrees to exercise expenditure responsibility for all outstanding grants made by *P*. The day after *P* distributes all of its assets, *P* files articles of dissolution with the appropriate state authority.

SITUATION 2

T, a charitable trust, is recognized as exempt from federal tax under § 501(c)(3) and is classified as a private foundation under § 509(a). The trustees of *T* determine that *T*'s charitable purposes can be more effectively accomplished by operating in corporate form.

The trustees of *T* create *W*, a not-for-profit corporation, for the purpose of carrying on *T*'s activities. *W* is recognized as exempt from federal tax under § 501(c)(3) and is classified as a private foundation under § 509(a). *T* transfers all of its assets and liabilities to *W*.

SITUATION 3

J and *K* are not-for-profit corporations that are recognized as exempt from federal tax under § 501(c)(3) and are classified as private foundations under § 509(a). *J* and *K* generally confine their grantmaking activities to supporting charitable programs in the city in which both *J* and *K* are located.

V, a newly-formed entity, is recognized as exempt from federal tax under § 501(c)(3) and is classified as a private foundation under § 509(a). To eliminate the costs of maintaining two private foundations with identical charitable purposes, *J* and *K* transfer all of their assets and liabilities to *V*.

LAW

Section 507(a) provides that, except as provided in § 507(b), the status of any organization as a private foundation shall be terminated only if: (1) such organization notifies the Secretary of its intent to accomplish such termination, or (2) with respect to such organization, there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to a liability for tax under chapter 42, and the Secretary notifies such organization that it is liable for the tax imposed by § 507(c). Under § 507(a)(1) and (2), the organization's private foundation status is terminated when the organization pays the tax imposed by § 507(c) or the entire amount of such tax is abated under § 507(g). The person currently designated to receive the notice of termination described in § 507(a)(1) is Manager, Exempt Organizations Determinations (TE/GE).

Section 507(b)(2) provides that in the case of a transfer of assets of any private foundation to another private foundation pursuant to a liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization, the transferee foundation shall not be treated as a newly created organization.

Section 507(c) imposes a tax on each organization whose private foundation status is voluntarily or involuntarily terminated under § 507(a). The tax imposed is equal to the lower of: (1) the amount which the private foundation substantiates by adequate records or other corroborating evidence as the aggregate tax benefit resulting from the § 501(c)(3) status of such foundation, or (2) the value of the net assets of the foundation.

Section 1.507–1(b)(6) of the Income Tax Regulations provides that if a private foundation transfers all or part of its assets to one or more other private foundations pursuant to a transfer described in

§ 507(b)(2) and § 1.507–3(c), such transferor foundation will not have terminated its private foundation status under § 507(a)(1).

Section 1.507–1(b)(7) provides that a transfer of all the assets of a private foundation does not result in a termination of the transferor private foundation under § 507(a), unless the transferor private foundation elects to terminate pursuant to § 507(a)(1), or § 507(a)(2) is applicable.

Section 1.507–3(a)(1) provides that, in a § 507(b)(2) transfer, a transferee organization will not be treated as a newly created organization. The transferee organization is treated as possessing those attributes and characteristics of the transferor organization which are described in § 1.507–3(a)(2), (3) and (4).

Section 1.507–3(a)(2)(i) provides that a transferee organization shall succeed to the aggregate tax benefit of the transferor organization in an amount equal to the amount of such aggregate tax benefit multiplied by a fraction the numerator of which is the fair market value of the assets (less encumbrances) transferred to such transferee and the denominator of which is the fair market value of the assets of the transferor (less encumbrances) immediately before the transfer.

Section 1.507–3(a)(3) provides that, in the event of a transfer of assets under § 507(b)(2), any person who is a substantial contributor with respect to the transferor foundation shall be treated as a substantial contributor with respect to the transferee foundation, regardless of whether such person meets the $5,000 two-percent test with respect to the transferee at any time. If a private foundation makes a transfer described in § 507(b)(2) to two or more transferee private foundations, any person who is a substantial contributor with respect to the transferor foundation prior to such transfer shall be considered a substantial contributor with respect to each transferee.

Section 1.507–3(a)(4) provides that if a private foundation incurs liability for one or more of the taxes imposed under chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in § 507(b)(2) to one or more private foundations, in any case where transferee liability applies each transferee foundation shall be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.

Section 1.507–3(a)(5) provides that, except as provided in § 1.507–3(a)(9), a private foundation is required to meet the distribution requirements of § 4942 for any taxable year in which it makes a § 507(b)(2) transfer of all or part of its net assets to another private foundation.

Section 1.507–3(a)(6) provides that whenever a private foundation makes a § 507(b)(2) transfer of all or part of its net assets to another private foundation, the applicable period of time described in § 4943(c)(4), (5), or (6) shall include both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets.

Section 1.507–3(a)(7) provides that, except as provided in § 1.507–3(a)(9), where the transferor has disposed of all of its assets, during any period in which the transferor has no assets, § 4945(d)(4) and (h) shall not apply to the transferee or the transferor with respect to any expenditure responsibility grants made by the transferor. However, the information reporting requirements under § 4945 will apply for any year in which any such transfer is made.

Section 1.507–3(a)(9)(i) provides that if a private foundation transfers all of its net assets to one or more private foundations that are effectively controlled, directly or indirectly, by the same person or persons that effectively controlled the transferor private foundation, the transferee private foundation will be treated as if it were the transferor private foundation for purposes of §§ 4940 through 4948 and §§ 507 through 509. However, where proportionality is appropriate, such a transferee foundation shall be treated as if it were the transferor in the proportion which the fair market value of the assets (less encumbrances) transferred to such transferee bears to the fair market value of the assets (less encumbrances) of the transferor immediately before the transfer.

Section 1.507–3(a)(9)(ii) provides that § 1.507–3(a)(9)(i) shall not apply to the requirements under § 6033, which must be complied with by the transferor foundation, nor to the requirement under § 6043 that the transferor foundation file a return with respect to its liquidation, dissolution or termination.

Section 1.507–3(a)(9)(iii) (example 2) provides that if the transferees of a § 507(b)(2) transfer are effectively controlled by the same persons who control the transferor, each transferee is required to exercise expenditure responsibility with respect to the transferor's outstanding grants, unless, as part of the transfer, the transferor assigns and one or more transferees assume the transferor's expenditure responsibility, in which case, only the transferees assuming the transferor's expenditure responsibility are required to exercise such expenditure responsibility. Section 1.507–3(a)(9)(iii) (example 2) also provides that because such transferee foundations are treated as the transferor, rather than as recipients of expenditure responsibility grants, there are no expenditure responsibility requirements which must be exercised under § 4945(d)(4) and (h) with respect to the § 507(b)(2) transfer.

Section 1.507–3(a)(10), by reference to § 1.507–1(b)(9), provides that a private foundation that transfers all of its net assets is required to file the annual information return required by § 6033 for the taxable year in which such transfer occurs. However, the foundation will not be required to file such return for any taxable year following the taxable year in which the last of such transfers occurred, provided the foundation does not hold equitable title to any assets or engage in any activity during such subsequent taxable year.

Section 1.507–3(c)(1) provides that for purposes of § 507(b)(2), the terms "other adjustment, organization, or reorganization" shall include any partial liquidation or any other significant disposition of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income.

Section 1.507–3(c)(2) provides that the term "significant disposition of assets to one or more private foundations" includes any disposition (or series of related dispositions) by a private foundation to one or more private foundations of 25 percent or more of the fair market value of the net assets of the transferor foundation at the beginning of the taxable year in which the transfers occur.

Section 1.507–3(d) provides that unless a private foundation voluntarily gives notice pursuant to § 507(a)(1), a transfer of assets described in § 507(b)(2) will not constitute a termination of the transferor's private foundation status under § 507(a)(1).

Section 1.507–4(b) provides that private foundations which make transfers described in § 507(b)(2) are not subject to the tax imposed under § 507(c) with respect to such transfers unless the provisions of § 507(a) become applicable.

Section 1.507–7(a) provides that the net value of assets for purposes of § 507(c) shall be determined at whichever time such value is higher: (1) the first day on which action is taken by the organization which culminates in its ceasing to be a private foundation, or (2) the date on which it ceases to be a private foundation.

Sections 1.507–7(b)(1) and 1.507–8 provide that in the case of a termination under § 507(a)(1), the date referred to in § 1.507–7(a)(1) shall be the date on which the terminating foundation gives the notification described in § 507(a)(1).

Section 4940(a) generally imposes an excise tax on a private foundation's net investment income for the taxable year.

Section 4940(c)(1) defines net investment income as the amount by which the sum of the gross investment income and the capital gain net income exceeds the deductions allowed under § 4940(c)(3).

Section 4941(a)(1) imposes a tax on each act of self-dealing between a disqualified person and a private foundation. Section 53.4946–1(a)(8) provides that, for purposes of § 4941, the term "disqualified person" shall not include any organization described in § 501(c)(3) (other than an organization described in § 509(a)(4)).

Section 4942(a) generally imposes a tax on the undistributed income of a private foundation (other than an operating foundation under § 4942(j)(3)) for any taxable year, which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year.

Section 4942(c) defines "undistributed income" for any taxable year as the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made out of such distributable amount for such taxable year.

Section 4942(d) defines "distributable amount" as the amount equal to the sum of the minimum investment return, plus certain other amounts, reduced by the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and § 4940.

Section 4942(g)(1)(A) defines "qualifying distribution" as any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in § 170(c)(2)(B) other than a contribution to: (i) an organization controlled directly or indirectly by the foundation or by one or more disqualified persons with respect to the foundation, unless certain requirements are satisfied, or (ii) any private foundation which is not an operating foundation under § 4942(j)(3), unless certain requirements are satisfied.

Section 4942(i) provides for a carryover of the amount by which qualifying distributions during the five preceding taxable years (other than amounts required to be distributed out of corpus under § 4942(g)(3)) have exceeded the distributable amounts for such years.

Rev. Rul. 78–387 (1978–2 C.B. 270) holds that when a private foundation transfers all its assets to another private foundation that is controlled by the same persons who controlled the transferor foundation, the transferee foundation may reduce its distributable amount under § 4942(d) by the amount of the transferor's excess qualifying distributions as described in § 4942(i).

Section 4943(a)(1) imposes a tax on the "excess business holdings" (as defined in § 4943(c)) of any private foundation in a business enterprise.

Section 4944(a)(1) imposes a tax on any amount invested by a private foundation in a manner that jeopardizes the carrying out of any of the foundation's exempt purposes.

Section 4945 imposes a tax on any "taxable expenditure" (as defined in § 4945(d)) made by a private foundation.

Section 4945(d)(4) provides that the term "taxable expenditure" includes any amount paid or incurred as a grant to a private non-operating foundation unless the grantor foundation exercises expenditure responsibility with respect to such grant in accordance with § 4945(h).

Section 4945(h) provides that the expenditure responsibility referred to in § 4945(d)(4) means a private foundation is responsible to exert all reasonable efforts and to establish adequate procedures to: (1) see that the grant is spent solely for the purpose for which made, (2) obtain full and complete reports from the grantee on how the funds are spent, and (3) make full and detailed reports with respect to such expenditures to the Secretary.

Section 4946(a)(1) defines a "disqualified person" for purposes of subchapter A of chapter 42.

Section 6033(a)(1) provides that, with certain exceptions, every organization exempt from taxation under § 501(a) shall file an annual return.

Section 6043(b) and § 1.6043–3(a)(1) provide that, with certain exceptions, a private foundation must provide information with respect to a liquidation, dissolution, termination or substantial contraction as required by the instructions accompanying the foundation's annual return.

ANALYSIS

SECTION 507

Section 507(b)(2) applies to a significant disposition of assets by one private foundation to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. *See* § 1.507–3(c)(1). A transfer of all of a private foundation's assets to one or more private foundations constitutes a significant disposition. *See* § 1.507–3(c)(2). In Situations 1, 2 and 3, each transferor foundation transfers all of its assets to one or more private foundations. The transfers are not for full and adequate consideration and are not distributions out of current income. Thus, the transfers in Situations 1, 2 and 3 are § 507(b)(2) transfers.

A transfer of assets described in § 507(b)(2) does not constitute a termination of the transferor's private foundation status under § 507(a)(1) unless the transferor voluntarily gives notice pursuant to § 507(a)(1). *See* §§ 1.507–1(b)(6) and 1.507–3(d). The transferor foundation is not required to provide such notice. In Situation 1, *P*'s dissolution under state

law has no effect on whether *P* has terminated its private foundation status for federal tax purposes.

In Situations 1, 2, and 3, if the transferor foundation does not give notice to the Manager, Exempt Organizations Determinations (TE/GE), of its intent to terminate, the transferor retains its private foundation status and the § 507(c) tax does not apply. *See* § 507(a)(1) and § 1.507–4(b). The transferor foundation is required to file a Form 990–PF for the taxable year of the transfer(s), but is not required to file a Form 990–PF for subsequent taxable years during which it does not have equitable title to any assets and does not engage in any activity. *See* §§ 6033(a)(1) and 6043(b), and §§ 1.507–1(b)(9) and 1.507–3(a)(10). If, at any time following the transfer(s), the transferor foundation receives additional assets or engages in any activity, the transferor foundation must file a Form 990–PF. Additionally, because the transferor foundation has not terminated its private foundation status, the transferor foundation continues to be treated as a private foundation.

In Situations 1, 2, and 3, if the transferor foundation does give notice to the Manager, Exempt Organizations Determinations (TE/GE), of its intent to terminate, then the § 507(c) tax applies on the date such notice is given. *See* § 1.507–7(a) and (b)(1). Thus, in Situations 1, 2, and 3, if the transferor foundation provides notice at least one day after it transfers all of its assets, the tax imposed by § 507(c) will be zero. The transferor foundation is required to file a Form 990–PF for the taxable year of the transfer(s). *See* §§ 6033(a)(1) and 6043(b).

Regardless of whether the transferor foundation provides notice of its intent to terminate, the transferee foundations are treated as possessing the aggregate tax benefit of the transferor foundations. *See* § 1.507–3(a)(1) and (2)(i). In Situation 1, *X*, *Y*, and *Z* succeed to *P*'s aggregate tax benefit in proportion to the assets transferred to each. *See* § 1.507–3(a)(2)(i).

Moreover, regardless of whether the transferor foundation provides notice of its intent to terminate, where transferee liability applies, each transferee foundation is treated as receiving the transferred assets subject to the transferor foundation's prior excise tax liabilities under chapter 42 (and any penalties resulting therefrom), if any, to the extent the transferor did not previously satisfy those liabilities. *See* § 1.507–3(a)(1) and (4).

SECTION 4940

In Situations 1, 2 and 3, the transfers do not constitute investments of the transferor for purposes of § 4940; therefore, the transfers do not give rise to net investment income subject to tax under § 4940(a).

In Situations 1, 2, and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, any excess § 4940 tax paid by the transferor may be used by the transferees to offset the transferees' § 4940 tax liability. *See* § 1.507–3(a)(9)(i). In Situation 1, where there are several transferees, proportionality is appropriate, and *X*, *Y*, and *Z* will each succeed to one third of any excess § 4940 tax paid by *P*. *See* § 1.507–3(a)(9)(i).

SECTION 4941

In Situations 1, 2 and 3, the transfers are to § 501(c)(3) organizations, which are not treated as disqualified persons for purposes of § 4941. *See* § 53.4946–1(a)(8). Thus, the transfers do not constitute self-dealing transactions and are not subject to tax under § 4941(a)(1).

SECTION 4942

In Situations 1, 2 and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of § 4942. *See* § 1.507–3(a)(9)(i). Accordingly, the transfers to the transferee foundations are not treated as qualifying distributions of the transferor foundation. In addition, in Situations 2 and 3, each transferee foundation assumes all obligations with respect to the transferor's "undistributed income" within the meaning of § 4942(c), if any, and reduces its own distributable amount under § 4942 by the transferor foundation's excess qualifying distributions under § 4942(i). In Situation 1, where there are several transferee foundations, proportionality is appropriate, and *X*, *Y* and *Z* each becomes responsible for one third of *P*'s undistributed income and succeeds to one third of *P*'s excess qualifying distributions, if any. *See* § 1.507–3(a)(9)(i) and Rev. Rul. 78–387.

SECTION 4943

Whether the transfers cause a transferee foundation to have excess business holdings and be subject to tax under § 4943(a) depends on the facts and circumstances. In Situations 1, 2, and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of §§ 4943 and 4946. *See* § 1.507–3(a)(9)(i). Accordingly, in determining whether a transferee foundation has excess business holdings, the disqualified persons of the transferee foundation are determined in part by treating the transferee as though it were the transferor. For example, both the substantial contributors of the transferee and the substantial contributors of the transferor are treated as a disqualified persons of the transferee in determining whether the transferee has excess business holdings as a result of the transfer. *See* § 4946(a)(1)(A) and § 1.507–3(a)(9)(i); *see also* § 1.507–3(a)(3). In addition, in determining whether a transferee foundation is subject to tax under § 4943, the transferee's holding period in the transferred assets for purposes of § 4943(c)(4), (5), and (6) includes both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets. *See* § 1.507–3(a)(6).

SECTION 4944

In Situations 1, 2, and 3, the transfers do not constitute investments for purposes of § 4944; therefore the transfers do not constitute investments jeopardizing the transferor foundation's exempt purposes and are not subject to tax under § 4944(a)(1).

In Situations 1, 2, and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of § 4945. *See* § 1.507–3(a)(9)(i). Because the transferee foundations are treated as the transferor foundation rather than as recipients of expenditure responsibility grants, there are no expenditure responsibility requirements that must be exercised under § 4945(d)(4) or (h) with respect to the transfers to the transferee foundations. *See* § 1.507–3(a)(9)(i) and (iii)(example 2).

The transferor foundation is required to exercise expenditure responsibility over the transferor's outstanding grants until the transferor disposes of all of its assets. Thereafter, during any period in which the transferor foundation has no assets, the transferor foundation is not required to exercise expenditure responsibility over any outstanding grants. *See* § 1.507–3(a)(7). However, the transferor foundation still must meet the § 4945(h) reporting requirements for the outstanding grants for the year in which the transfers are made. *See* § 1.507–3(a)(7).

The transferee foundations assume expenditure responsibility for all the transferor's outstanding grants. *See* § 1.507–3(a)(9)(i). In Situation 1, because *X* agreed to exercise expenditure responsibility for all of *P*'s outstanding grants, *Y* and *Z* have no expenditure responsibility over *P*'s grants. However, in the absence of such an agreement, *X*, *Y* and *Z* each would be required to exercise expenditure responsibility with respect to all of *P*'s outstanding grants. *See* § 1.507–3(a)(9)(i) and (iii) (example 2).

HOLDINGS

(1) A private foundation that transfers all of its assets to one or more private foundations in a transfer described in § 507(b)(2) is not required to notify the Manager, Exempt Organizations Determinations (TE/GE), that it plans to terminate its private foundation status under § 507(a)(1). If the private foundation does not provide notice and does not terminate, the private foundation is not subject to the § 507(c) termination tax. If the private foundation chooses to provide notice, and therefore terminates, it is subject to the § 507(c) tax; however, if the private foundation has no assets on the day it provides notice (*e.g.*, it provides notice at least one day after it transfers all of its assets), the § 507(c) tax will be zero.

(2) (a) A private foundation that has disposed of all of its assets and terminates its private foundation status must file a Form 990–PF for the taxable year of the disposition and must comply with any expenditure responsibility reporting obligations on such return.

(b) A private foundation that has disposed of all of its assets and does not terminate its private foundation status must file a Form 990–PF for the taxable year of the disposition and must comply with any expenditure responsibility reporting obligations on such return, but does not need to file returns in the following taxable years if it has no assets and does not engage in any activities. If, in later taxable years, it receives additional assets or resumes activities, it must resume filing a Form 990–PF for those taxable years in which it has assets or activities.

(3) Where transferee liability applies, each transferee foundation is treated as receiving the transferred assets subject to the transferor foundation's prior excise tax liabilities under chapter 42 (and any penalty resulting therefrom), if any, to the extent the transferor foundation did not previously satisfy those liabilities.

(a) The transfers do not give rise to net investment income and are not subject to tax under § 4940(a). The transferee foundations may use their proportionate share of any excess § 4940 tax paid by the transferor to offset their own § 4940 tax liability.

(b) The transfers do not constitute self-dealing and are not subject to tax under § 4941(a)(1).

(c) The transfers do not constitute qualifying distributions for the transferor foundation under § 4942. The transferee foundations assume their proportionate share of the transferor foundation's undistributed income under § 4942 and reduce their own distributable amount for purposes of § 4942 by their proportionate share of the transferors' excess qualifying distributions under § 4942(i).

(d) Whether the transfers cause a transferee foundation to have excess business holdings and be subject to tax under § 4943(a) depends on the facts and circumstances. In making these determinations, the disqualified persons of a transferee foundation are determined in part by treating the transferee as though it were the transferor. In addition, the transferee's holding period in the transferred assets for purposes of § 4943(c)(4), (5) and (6) includes both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets.

(e) The transfers do not constitute investments jeopardizing the transferor foundation's exempt purposes and are not subject to tax under § 4944(a)(1).

(f) The transferor foundation is not required to exercise expenditure responsibility under § 4945(h) with respect to the transfers. The transferor foundation is required to exercise expenditure responsibility over any outstanding grants until the time it disposes of all of its assets and must satisfy the § 4945(h) reporting requirements for the taxable year in which the transfers were made. Following the transfers and during any period in which the transferor has no assets or activities, the transferor foundation is not required to exercise expenditure responsibility with respect to any of its outstanding grants.

Each transferee foundation must exercise expenditure responsibility with respect to all outstanding grants by the transferor foundation. If, however, the transferor foundation assigns and transferees assume the transferor's expenditure responsibility with respect to a grant, only the transferees assuming the transferor's expenditure responsibility are required to exercise such expenditure responsibility with respect to such grant.

(4) The transferor foundation's aggregate tax benefits under § 507(d) are transferred to the transferee foundations in proportion to the transferor's assets transferred to each transferee.

DRAFTING INFORMATION

The principal author of this revenue ruling is Theodore R. Lieber of the Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, contact Theodore R. Lieber at (202) 283–8999 (not a toll-free call).

Section 1092.—Straddles

26 CFR 1.1092(c)–1: Qualified covered calls.

T.D. 8990

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Equity Options With Flexible Terms; Qualified Covered Call Treatment

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations providing guidance on the application of the rules governing qualified covered calls. The new rules address concerns that were created by the introduction of new financial instruments several years after the enactment of the qualified covered call rules. The final regulations provide guidance to taxpayers writing equity call options.

DATES: *Effective Date*: These regulations are effective April 29, 2002.

Applicability Date: For dates of applicability, see §§ 1.1092(c)–1(c), 1.1092(c)–2(d), 1.1092(c)–3(c), and 1.1092(c)–4(g).

FOR FURTHER INFORMATION CONTACT: Pamela Lew, (202) 622–3950 or Viva Hammer, (202) 622–0869 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On January 18, 2001, the IRS published in the **Federal Register** proposed regulations (REG–115560–99, 2001–1 C.B. 993 [66 F.R. 4751]) addressing various issues concerning qualified covered call (QCC) options under section 1092(c)(4). No requests to speak at a public hearing were received, and no public hearing was held.

The proposed regulations provide that equity options with flexible terms (FLEX options) may be QCC options as long as they satisfy the general rules for QCC treatment described in section 1092(c)(4), are not for a term of longer than one year, and meet other specified requirements. In addition, an equity option with standardized terms must be outstanding for the underlying equity. For purposes of applying the general rules, the bench marks will be the same as those for an equity option with standardized terms on the same stock having the same applicable stock price.

The proposed regulations also provide that certain over-the-counter (OTC) options may be QCC options so that OTC options that are economically similar to FLEX options may receive the same tax treatment as FLEX options. Specifically, the proposed regulations provide that an OTC option is eligible for QCC treatment if it is entered into with a person registered with the Securities and Exchange Commission (SEC) as a broker-dealer or alternative trading system and meets the same requirements for QCC treatment that apply to FLEX options.

The proposed regulations further provide that equity options with standardized terms with maturities of longer than one year cannot be QCC options.

Comments were requested about the proposed one-year limit for all QCCs, including a discussion of time limitations in general. If a commentator recommended a time limitation greater than one year or recommended that there be no time limitation, a detailed, comprehensive description of possible solutions to the problem of increased risk reduction caused by longer term options was requested. Commentators were also asked to address the administrability of any proposed solutions.

After revisions to take into account several of the comments submitted, the proposed regulations are adopted by this Treasury decision.

Summary of Principal Comments

Four commentators responded to the request for comments. Two of the commentators addressed only the proposed 1-year limitation applicable to all QCC options. A third commentator addressed the proposed 1-year limit as well as a number of other issues. The fourth commentator focused on issues other than the proposed 1-year limitation.

One-year Term Limitation

A number of commentators object to the proposal to limit QCC treatment to options with a duration of one year or less. These commentators note that the statute does not contain any limitation on the maximum term for QCCs and argue that a one-year limitation would be overly harsh. Among other things, they note that a strict one-year rule would preclude QCC status for even out-of-the-money options. One commentator notes that section 1092(c)(4) does not remove a QCC option completely from the straddle rules. Paragraphs (c)(4)(E) and (f) of section 1092 provide special limitations on QCCs for recognition of loss and suspension of holding period.[1] This commentator suggests that these rules limit the extent to which longer-term QCCs would lead to results inconsistent with the purposes of section 1092.

In response to the request in the preamble to the proposed regulation for alternative regimes to address the

[1] Under section 1092(c)(4)(E), the exception for QCCs does not apply to a covered call that would otherwise qualify for the exception if one leg is disposed of at a loss in one year, gain on the other position is includible for a later year, and less than 30 days has elapsed between these transactions. Under section 1092(f), if a taxpayer grants an in-the-money QCC, then loss on the call is treated as long-term capital loss if gain on the underlying stock would be long-term capital gain. In addition, the holding period is suspended for the period during which the taxpayer is the grantor of the option.

increased risk reduction created by longer-term options, two commentators suggest an adjustment to the "applicable stock price" to reflect forward pricing concepts. These commentators suggest that the unadjusted applicable stock price, as determined on the date the option is granted, be multiplied by a simple adjusting factor to produce an applicable stock price adjusted for the passage of time. For each additional term year, the factor would be increased by 5%. For example, the factor for a one-to-two year option would be 105%, and the factor for a two-to-three year option would be 110 %. The adjusted applicable stock price would then be used to determine the applicable benchmarks and the lowest permitted QCC strike price. The commentators prefer, however, no limitation on the term of QCC options.

Clarification of "single fixed strike price"

Proposed § 1.1092(c)–1(c)(1)(ii) requires a QCC option to have "a single fixed strike price stated as a dollar amount." One commentator suggests that this phrase does not account for adjustments to the strike price due to certain corporate events, such as stock splits, stock dividends, spin-offs, mergers, or substantial cash dividends that reduce the market value of the stock by at least 10%. For example, a strike price might not be considered fixed if the underlying stock split two-for-one and the option's strike price were adjusted to one-half of its original strike price. The commentator recommends that the language be modified to account for these events.

Clarification That the Lowest Qualified Benchmark for a FLEX Option is the Same as for an Equity Option with Standardized Terms

Proposed § 1.1092(c)–1(c)(2)(i) provides that to determine whether a FLEX option is deep in the money, the taxpayer must use the same lowest qualified benchmark that is used for a standardized option on the same stock having the same applicable stock price. One commentator argues that the language in the proposed regulation is ambiguous. The commentator suggests that the language in the proposed regulation be changed to provide that the lowest qualified benchmark for a FLEX option is equal to the lowest *available* strike price at which a standardized call option can be written without being deep in the money.

Requirement That an Equity Option with Standardized Terms Exist at the Time an Equity Option with Flexible Terms or Qualifying Over-the-counter Option is Written

Under § 1.1092(c)–1(c)(1)(iv) of the proposed regulation, a FLEX option can be a QCC option only if "[a]n equity option with standardized terms is outstanding for the underlying equity." Under exchange rules, trading in a FLEX option cannot be *authorized* unless trading in a standardized option on the same stock has been *authorized.* Although a commentator believes it unlikely that a FLEX option would be written on a stock for which there were no outstanding standardized options, the commentator sees no reason to impose this restriction. Thus, the commentator recommends that the word "available" be substituted for the word "outstanding."

Clarification of "equity option with standardized terms"

Under proposed § 1.1092(c)–1(d)(3), an equity option with standardized terms is defined as "an equity option that is traded on a national securities exchange registered with the Securities and Exchange Commission and that is not an equity option with flexible terms." One commentator notes that there is no definition of "equity option" and wonders whether the definition of equity option in section 1256(g) applies here. That definition would include options on narrow based indexes. In addition, because an equity option with standardized terms is defined as a negative (*i.e.*, anything that is not a FLEX option), if the exchanges approve a new option product that does not meet the definition of FLEX option, that product might meet the definition of a standardized option, thus affecting the application of the regulations for FLEX options. The commentator did not provide alternative regulatory language.

Clarification of "entered into with"

Under proposed § 1.1092(c)–3(c)(2)(i), a qualifying OTC option must be "entered into with" a person registered with the SEC as a broker-dealer. One commentator is concerned that this phrase implies that the broker-dealer must act as a principal in the transaction. The commentator requests that the language be modified to say that the broker-dealer may be a principal to the transaction or may serve as an agent.

Add Banks to the List of Parties With or Through Whom a QCC May Be Transacted

One commentator requests that banks be added to the list of parties with or through whom a QCC transaction may be effected. The commentator notes that under the Gramm-Leach-Bliley Act, Public Law 106–102, 113 Stat. 1338 (1999), banks will be required to interpose a broker-dealer registered with the SEC in transactions with customers who are not "qualified investors." Banks will be permitted to function as broker-dealers with respect to "qualified investors."

The commentator suggests defining a bank as a "bank within the meaning of section 3(a)(6) of the Securities Exchange Act of 1934 and the regulations adopted thereunder." The commentator argues that any such bank would be subject to a banking regulatory authority within the United States and would generally be subject to recordkeeping requirements.

Explanation of Provisions

Limitation of Option Term

As originally enacted in 1981, section 1092 did not apply to stock or to options on stock. In the legislative history to the Tax Reform Act of 1984, the House Ways and Means Committee stated that taxpayers had attempted to exploit the exemption from the loss-deferral rule for exchange-traded stock options to defer tax on income from unrelated transactions. H. Rep. No. 432, 98th Cong., 2d Sess. 1266 (1984). The Committee stated that a typical abusive stock option straddle "involves the acquisition of 'deep-in-the-money' offsetting option positions. Regardless of whether the

value of the underlying stock increases or decreases, one option position will result in a loss that can be realized for tax purposes, while the other position results in a gain of approximately equal size that can be deferred until the next year." *Id.* In response to these concerns, Congress generally ended the exemption from the straddle rules for stock and exchange-traded options.

The House Ways and Means Committee noted, however, that the extension of the straddle rules to stock options and stock would affect the widely used investment strategy of writing call options on stock owned by the taxpayer. The Committee stated that it might be appropriate to exempt transactions that were undertaken primarily to enhance the taxpayer's investment return on the stock and not to reduce the taxpayer's risk of loss on the stock. Congress therefore amended section 1092 to permit a taxpayer owning stock and writing a covered call option generally to avoid straddle treatment if certain conditions were met. One condition was that the strike price of the call could not be less than a statutorily-prescribed level relative to the market price of the underlying stock. In establishing this exception to the straddle rules, Congress granted the Secretary broad regulatory authority to modify section 1092 to take account of changes in the practices of options exchanges or to prevent tax avoidance.

Since 1984, numerous changes have occurred in the practices of options exchanges. In 1984, no exchange-traded option had a term of greater than nine months. By contrast, certain exchange-traded options currently may have terms of up to 33 months. In light of these changes, the IRS and Treasury have considered certain economic characteristics of qualified covered call transactions as they relate to the risk reduction effects of longer-term options.

One way of looking at the risk reduction effect of a covered call option focuses on the day-to-day (or intra-day) relative changes in value of the stock and the option. In general, the values of stock and a written call option on the stock vary inversely when viewed from the perspective of the person owning the stock and writing a call option. Each movement in the stock price produces a movement in the value of the written call that, at least partially, offsets the change in value of the long position in the stock.

Modern option pricing literature describes this relationship between the change in value of the underlying stock and the change in value of the option using the parameter "Delta". If a change in value of the stock results in an equal movement in the value of the option, Delta equals 1. If the change in value of the option is less than the change in value of the stock, then Delta is less than 1. From the perspective of a call option writer, because of the inverse relationship between changes in stock price and changes in option value described above, Delta represents the amount of offset that a change in stock value has upon the value of the written call option. Delta values vary with a number of factors, including the extent to which the option is in or out of the money and the term of the option. All else being equal, longer-term options have higher Delta values and, therefore, have a greater risk reduction potential than short-term options with respect to movements in stock prices.

Another economic characteristic of longer-term covered call options is increased potential for the immediate recognition of a stock loss and the deferral of any gain arising from a related option. As noted above, when section 1092(c)(4) was enacted, no qualified covered call option had a term of more than nine months, and the mismatch for a QCC thus could not have spanned more than one taxable year. With the advent of longer-term options, the potential for a mismatch between a loss and the deferral of related income can extend over many taxable years, which may not have been contemplated by Congress when the QCC provisions were enacted.

After reviewing taxpayers' comments received in light of these economic considerations, the IRS and Treasury have decided to adopt a forward pricing approach for the determination of the applicable stock price for an option with a term greater than 12 months. To determine the applicable stock price for an option with a term greater than 12 months, taxpayers are required to multiply the statutory applicable stock price by a factor, which represents a noncompounded two percent per quarter increase in the applicable strike price. Based on certain assumptions regarding the volatility of the underlying stock and the risk-free interest rate, the use of such factors for options with a relatively short term (*i.e.*, 33 months or less) will produce Deltas that are generally similar to those for a nine-month option with no adjustment to the applicable strike price. Because no exchange-traded option currently has a term of more than 33 months, and because the application of the approach set forth above to options with terms longer than 33 months may permit the use of such options for tax avoidance, the IRS and Treasury believe that it would be inappropriate to extend this approach to such options. Thus, no option will constitute a qualified covered call option if it has a term of greater than 33 months. Additional guidance about the maximum term limit may be provided by the Commissioner in guidance published in the Internal Revenue Bulletin. This could occur, for example, if the option exchanges commence trading of equity options with standardized terms that expire more than 33 months after the date of issuance.

The definition of a QCC option also affects a number of other Code sections. These are generally provisions that require a taxpayer to bear economic risk with respect to an asset for purposes of establishing a requisite holding period in the asset. See sections 246(c)(1), 852(b)(4)(C), 857(b)(8)(B), 901(k)(5), 1059(d)(3), and 1259(c)(3)(A)(iii). The IRS and the Treasury have taken into account the interaction of the QCC qualification rules and these other Code sections in light of the risk reduction potential of longer-term options. If, however, experience suggests that longer-term QCC options are being exploited to achieve risk reduction while allowing taxpayers to establish holding periods in ways that are inconsistent with another Code provision (*e.g.*, section 1259), the IRS and Treasury may reconsider the issue of term limitations for QCCs, either generally for purposes of section 1092 or specifically for purposes of such other Code provision.

Clarification of "single fixed strike price"

After consideration of the comment submitted, a definition for "single fixed strike price" is added at § 1.1092(c)–4(d), providing that adjustments to the strike price for certain significant corporate events subsequent to the writing of the option will not cause the option to fail the requirement of a single fixed strike price. The definition is intended to cover adjustments to the strike price made under Section 11 of Article VI of the Options Clearing Corporation By-Laws.

Clarification That the Lowest Qualified Benchmark for a FLEX Option is the Same as for an Equity Option with Standardized Terms

After consideration of the comment submitted, examples have been added at § 1.1092(c)–2(c)(2)(ii) to clarify that the lowest qualified benchmark for a FLEX option is the same as the lowest qualified benchmark for an equity option with standardized terms on the same stock having the same applicable stock price.

Requirement That an Equity Option with Standardized Terms Exist at the Time an Equity Option with Flexible Terms or Qualifying Over-the-counter Option is Written

After consideration of the comment submitted, the language is finalized as proposed.

This provision was inserted in the proposed regulation for two reasons. The first reason was to provide benchmarks for FLEX options. Because FLEX option strike prices can be written in one penny intervals, without this provision every FLEX option would be deep-in-the-money if the strike price were one penny less than the applicable stock price. By tying every FLEX option to a standardized option, the benchmarks are the strike prices set by the exchanges for standardized options. For this purpose, an authorized standardized option would suffice.

The second reason underlying this provision is to facilitate the discovery of attempts to use off-market pricing of FLEX options or qualifying OTC options as a method of effecting collateral transactions. If a FLEX option or qualifying OTC option were written for an off-market premium, that would warn of the potential for the existence of one or more other transactions. For example, a qualifying OTC option might be written by a corporation and held by a shareholder. If the premium were excessively low compared to that for a standardized option on that same stock, the additional value received by the holder might be appropriately characterized as a dividend. Thus, with an outstanding standardized option on the same stock, the existence of an excessively low premium for a FLEX option would be more transparent.

Clarification of "equity option with standardized terms"

After consideration of the comment submitted, a new definition for "equity option with standardized terms" is provided at § 1.1092(c)–4(b). The factors listed in this section were based on the rules of the exchanges establishing required provisions of exchange-traded equity options.

Clarification of "entered into with"

After consideration of the comment submitted, a clarification is added to § 1.1092(c)–4(c)(2)(i) to explain that the broker-dealer may be a principal to the transaction or can serve as an agent.

Add Banks to the List of Parties With or Through Whom a QCC May Be Transacted

After consideration of the comment submitted and review of the recordkeeping requirements of 12 CFR 12.3, 12 CFR 208.34, and 12 CFR 344.4, banks that are required to comply with these recordkeeping requirements are added to the list of parties with or through whom a qualifying over-the-counter option may be transacted.

Other Provisions

Section § 1.1092(c)–1 was redesignated § 1.1092(c)–2 to facilitate the insertion of the general term limitations applying to all QCC options. The definitions in former § 1.1092(c)–1(d) were moved to § 1.1092(c)–4 to facilitate consolidation of definitions that apply to QCC options.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the only category of small entities likely to be affected are small broker-dealers or small federally-regulated financial institutions who may be included among the financial intermediaries implementing the changes effected by these regulations. The requirements contained in these regulations do not impose more than a minimal compliance burden because the required changes in computer programs and back office procedures are insignificant. In addition, these regulations do not impose any recordkeeping or reporting requirements and therefore impose minimal compliance costs, if any, upon any small entities that may be affected. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Drafting Information

The principal authors of these regulations are Pamela Lew, Office of Associate Chief Counsel (Financial Institutions and Products) and Viva Hammer, Office of Tax Policy (Department of Treasury). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1092(c)–2 also issued under 26 U.S.C.1092(c)(4)(H).

Section 1.1092(c)–3 also issued under 26 U.S.C.1092(c)(4)(H).

Section 1.1092(c)–4 also issued under 26 U.S.C. 1092(c)(4)(H).* * *

Par. 2. Section 1.1092(c)–1 is redesignated as § 1.1092(c)–2.

Par. 3. A new § 1.1092(c)–1 is added to read as follows:

§ 1.1092(c)–1 Qualified covered calls.

(a) *In general*. Section 1092(c) defines a straddle as offsetting positions with respect to personal property. Under section 1092(d)(3)(B)(i)(I), stock is personal property if the stock is part of a straddle that involves an option on that stock or substantially identical stock or securities. Under section 1092(c)(4), however, writing a qualified covered call option and owning the optioned stock is not treated as a straddle under section 1092 if certain conditions, described in section 1092(c)(4)(B), are satisfied. Section 1092(c)(4)(H) authorizes the Secretary to modify these conditions to carry out the purposes of section 1092(c)(4) in light of changes in the marketplace.

(b) *Term limitation*—(1) *General rule*. Except as provided in paragraph (b)(2) of this section, an option is not a qualified covered call unless it is granted not more than 12 months before the day on which the option expires or satisfies term limitation and qualified benchmark requirements established by the Commissioner in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Special benchmark rule for an option granted not more than 33 months before the day on which the option expires* (i) *In general*. The 12-month limitation described in paragraph (b)(1) of this section is extended to 33 months provided the lowest qualified benchmark is determined using the adjusted applicable stock price, as defined in § 1.1092(c)–4(e).

(ii) *Examples*. The following examples illustrate the rules set out in paragraph (b)(2)(i) of this section:

Example 1. Taxpayer owns stock in Corporation X. Taxpayer writes an equity option with standardized terms on Corporation X stock through a national securities exchange with a term of 21 months. The applicable stock price for Corporation X stock is $100. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $100 will be based upon the adjusted applicable stock price. Using the table at § 1.1092(c)–4(e), the applicable stock price of $100 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $112. Using the bench marks for an equity option with standardized terms with an adjusted applicable stock price of $112, the highest available strike price less than the adjusted applicable stock price is $110, and the second highest strike price less than the adjusted applicable stock price is $105. Therefore, a 21-month equity call option with standardized terms on Corporation X stock will not be deep in the money if the strike price is not less than $105.

Example 2. Taxpayer owns stock in Corporation Y. Taxpayer writes an equity option with standardized terms on Corporation Y stock through a national securities exchange with a term of 21 months. The applicable stock price for Corporation Y stock is $13.25. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $13.25 will be based upon the adjusted applicable stock price. Using the table at § 1.1092(c)–4(e), the applicable stock price of $13.25 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $14.84. Using the bench marks for an equity option with standardized terms with an adjusted applicable stock price of $14.84, the highest available strike price less than the adjusted applicable stock price is $12.50. However, under section 1092(c)(4)(D), the lowest qualified bench mark can be no lower than 85% of the applicable stock price, which for Corporation Y stock is $12.61 (85% of the adjusted applicable stock price of $14.84). Thus, because the highest available strike price less than the adjusted applicable stock price for an equity option with standardized terms is lower than the lowest qualified bench mark under section 1092(c)(4)(D), the lowest strike price at which a qualified covered call option can be written is the next higher strike price, or $15.00. Therefore, a 21-month equity call option with standardized terms on Corporation Y stock will not be deep in the money if the strike price is not less than $15.

(c) *Effective date*. This section applies to qualified covered call options entered into on or after July 29, 2002.

Par. 4. Section 1.1092(c)–4 is added to read as follows:

§ 1.1092(c)–4 Definitions.

The following definitions apply for purposes of §§ 1.1092(c)–1 through 1.1092(c)–3:

Par. 5. Section 1.1092(c)–2 is amended as follows:

1. Paragraph (b) is revised.
2. Paragraph (c) is added.
3. The paragraph in § 1.1092(c)–2 indicated in the first column is redesignated as a paragraph in § 1.1092(c)–4 as indicated in the second column as follows:

§ 1.1092(c)–2	§ 1.1092(c)–4
(d)(1) introductory text	(a) introductory text
(d)(1)(i) introductory text	(a)(1) introductory text
(d)(1)(i)(A)	(a)(1)(i)
(d)(1)(i)(B)	(a)(1)(ii)
(d)(1)(i)(C)	(a)(1)(iii)
(d)(1)(i)(D)	(a)(1)(iv)
(d)(1)(ii) introductory text	(a)(2) introductory text
(d)(1)(ii)(A)	(a)(2)(i)
(d)(1)(ii)(B)	(a)(2)(ii)
(d)(2)	(f)

4. Paragraph (d) is revised.
5. Paragraph (e) is removed.

The revisions and additions read as follows:

§ 1.1092(c)–2 Equity options with flexible terms.

* * * * *

(b) *No effect on lowest qualified bench mark for standardized options.* The availability of strike prices for equity options with flexible terms does not affect the determination of the lowest qualified bench mark, as defined in section 1092(c)(4)(D), for an equity option with standardized terms.

(c) *Qualified covered call option status*—(1) *Requirements.* An equity option with flexible terms is a qualified covered call option only if—

(i) The option meets the requirements of section 1092(c)(4)(B) and § 1.1092 (c)–1 (taking into account paragraph (c)(2) of this section);

(ii) The only payments permitted with respect to the option are a single fixed premium paid not later than 5 business days after the day on which the option is granted, and a single fixed strike price, as defined in § 1.1092(c)–4(d), that is payable entirely at (or within 5 business days of) exercise;

(iii) An equity option with standardized terms is outstanding for the underlying equity; and

(iv) The underlying security is stock in a single corporation.

(2) *Lowest qualified bench mark*—(i) *In general.* For purposes of determining whether an equity option with flexible terms is deep in the money within the meaning of section 1092(c)(4)(C), the lowest qualified bench mark under section 1092(c)(4)(D) is the same for an equity option with flexible terms as the lowest qualified bench mark for an equity option with standardized terms on the same stock having the same applicable stock price.

(ii) *Examples.* The following examples illustrate the rules set out in paragraph (c)(2)(i) of this section:

Example 1. Taxpayer owns stock in Corporation X. Taxpayer writes an equity call option with flexible terms on Corporation X stock through a national securities exchange for a term of not more than 12 months. The applicable stock price for Corporation X stock is $73.75. Using the bench marks for an equity option with standardized terms with an applicable stock price of $73.75, the highest available strike price less than the applicable stock price is $70, and the second highest strike price less than the applicable stock price is $65. Therefore, an equity call option with flexible terms on Corporation X stock with a term of 90 days or less will not be deep in the money if the strike price is not less than $70. If the term is greater than 90 days, an equity call option with flexible terms on Corporation X will not be deep in the money if the strike price is not less than $65.

Example 2. Taxpayer owns stock in Corporation Y. Taxpayer writes a 9-month equity call option with flexible terms on Corporation Y stock through a national securities exchange. The applicable stock price for Corporation Y stock is $14.75. Using the bench marks for an equity option with standardized terms with an applicable stock price of $14.75, the highest available strike price less than the applicable stock price is $12.50. However, under section 1092(c)(4)(D), the lowest qualified bench mark can be no lower than 85% of the applicable stock price, which for Corporation Y stock is $12.54. Thus, because the highest available strike price less than the applicable stock price for an equity option with standardized terms is lower than the lowest qualified bench mark under section 1092(c)(4)(D), the lowest strike price at which a qualified covered call option can be written is the next higher strike price, or $15.00. This $15.00 strike price requirement for a qualified covered call option applies to equity options with flexible terms, equity options with standardized terms, and qualifying over-the-counter options.

Example 3. Taxpayer owns stock in Corporation Z. On May 8, 2003, Taxpayer writes a 21-month equity call option with flexible terms on Corporation Z stock through a national securities exchange. The applicable stock price for Corporation Z stock is $100. The bench marks for a 21-month equity option with standardized terms with an applicable stock price of $100 will be based upon the adjusted applicable stock price. Using the table at §1.1092(c)–4(e), the applicable stock price of $100 is multiplied by the adjustment factor 1.12, resulting in an adjusted applicable stock price of $112. The highest available strike price less than the adjusted applicable stock price is $110, and the second highest strike price less than the adjusted applicable stock price is $105. Therefore, a 21-month equity call option with flexible terms on Corporation Z stock will not be deep in the money if the strike price is not less than $105.

(d) *Effective date*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, this section applies to equity options with flexible terms entered into on or after January 25, 2000.

(2) *Effective date for paragraphs (b) and (c) of this section.* Paragraphs (b) and (c) of this section apply to equity options with flexible terms entered into on or after July 29, 2002.

Par. 6. Section 1.1092(c)–3 is added to read as follows:

§ 1.1092(c)–3 Qualifying over-the-counter options.

(a) *In general.* Under section 1092(c)(4)(B)(i), an equity option is not a qualified covered call option unless it is traded on a national securities exchange that is registered with the Securities and Exchange Commission or other market that the Secretary determines has rules adequate to carry out the purposes of section 1092(c)(4). In accordance with section 1092(c)(4)(H), this requirement is modified as provided in paragraph (b) of this section.

(b) *Qualified covered call option status.* A qualifying over-the-counter option, as defined in § 1.1092(c)–4(c), is a qualified covered call option if it meets the requirements of §§ 1.1092(c)–1 and 1.1092(c)–2(c) after using the language "qualifying over-the-counter option" in place of "equity option with flexible terms". For purposes of this paragraph (b), a qualifying over-the-counter option is deemed to satisfy the requirements of section 1092(c)(4)(B)(i).

(c) *Effective date.* This section applies to qualifying over-the-counter options entered into on or after July 29, 2002.

Par. 7. Section 1.1092(c)–4 is further amended as follows:

1. Newly designated paragraphs (a)(1)(iv), (a)(2) introductory text, and (a)(2)(i) are revised.
2. Paragraphs (b), (c), (d), (e), and (g) are added.

The revisions and additions read as follows:

§ 1.1092(c)–4 Definitions.

* * * * *

(a) * * *

(1) * * *

(iv) Any changes to the Security Exchange Act Releases described in paragraphs (a)(1)(i) through (iii) of this section that are approved by the Securities and Exchange Commission; or

(2) That is traded on any national securities exchange that is registered with the Securities and Exchange Commission (other than those described in the Security Exchange Act Releases set forth in paragraph (a)(1) of this section) and is—

(i) Substantially identical to the equity options described in paragraph (a)(1) of this section; and
* * * * *

(b) *Equity option with standardized terms* means an equity option—

(1) That is traded on a national securities exchange registered with the Securities and Exchange Commission;

(2) That, on the date the option is written, expires on the Saturday following the third Friday of the month of expiration;

(3) That has a strike price that is set at a uniform minimum strike price interval, that is established by the applicable national securities exchange registered with the Securities and Exchange Commission, and that is not less than $1.00; and

(4) That has stock in a single corporation as its underlying security.

(c) *Qualifying over-the-counter option* means an equity option that—

(1) Is not traded on a national securities exchange registered with the Securities and Exchange Commission; and

(2) Is entered into with—

(i) A broker-dealer, acting as principal or agent, who is registered with the Securities and Exchange Commission under section 15 of the Securities Act of 1934 (15 U.S.C. 78a through 78mm) and the regulations thereunder and who must comply with the recordkeeping requirements of 17 CFR 240.17a–3; or

(ii) An alternative trading system under 17 CFR 242.300 through 17 CFR 242.303; or

(iii) A person, acting as principal or agent, who must comply with the recordkeeping requirements for securities transactions described in 12 CFR 12.3, 12 CFR 208.34, or 12 CFR 344.4.

(d) *Single fixed strike price* means a strike price that is fixed, determinable, and stated as a dollar amount on the date the option is written. An option will not fail to have a single fixed strike price if, after the date the option is written, the strike price is adjusted to account for the effects of a dividend, stock dividend, stock distribution, stock split, reverse stock split, rights offering, distribution, reorganization, recapitalization, or reclassification with respect to the underlying security, or a merger, consolidation, dissolution, or liquidation of the issuer of the underlying security.

(e) *Adjusted applicable stock price* means the applicable stock price, as defined in section 1092(c)(4)(G), adjusted for time. To determine the adjusted applicable stock price, the applicable stock price, which is determined in accordance with the rules in section 1092(c)(4)(G), is multiplied by an adjustment factor. The adjustment factor table is as follows:

Option Term		Adjustment Factor
Greater Than	Not More Than	
12 months	15 months	1.08
15 months	18 months	1.10
18 months	21 months	1.12
21 months	24 months	1.14
24 months	27 months	1.16
27 months	30 months	1.18
30 months	33 months	1.20

* * * * *

(g) *Effective dates*. (1) Except for paragraph (a)(2) of this section, paragraph (a) of this section applies to equity options with flexible terms entered into on or after January 25, 2000. Paragraph (a)(2) of this section applies to equity options with flexible terms entered into on or after July 29, 2002.

(2) Paragraphs (b), (c), (d), and (e) of this section apply to equity options entered into on or after July 29, 2002.

(3) Paragraph (f) of this section applies to equity options entered into on or after January 25, 2000.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 12, 2002.

Mark A. Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 26, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 29, 2002, 67 F.R. 20896)

Section 1400L.—Tax Benefits for New York Liberty Zone

How does a taxpayer elect not to deduct the additional first year depreciation provided by § 1400L(b) of the Internal Revenue Code for qualified New York Liberty Zone property and how does a taxpayer depreciate qualified New York Liberty Zone leasehold improvement property under § 1400L(c)? See Rev. Proc. 2002–33, page 963.

Section 1502.—Regulations

26 CFR 1.1502–75: Filing of consolidated returns.

WAIVER OF 60-MONTH BAR ON RECONSOLIDATION AFTER DISAFFILIATION. This procedure grants certain taxpayers a waiver of the general rule of § 1504(a)(3)(A) of the Code barring a corporation from filing a consolidated return with a group of which it had ceased to be a member for 60 months following the year of disaffiliation. The procedure clarifies and supersedes Rev. Proc. 91–71 (1991–2 C.B. 900). See Rev. Proc. 2002–32, page 959.

Section 1504.—Definitions

26 CFR 1.1504–1: Definitions (consolidated returns).

WAIVER OF 60-MONTH BAR ON RECONSOLIDATION AFTER DISAFFILIATION.

This procedure grants certain taxpayers a waiver of the general rule of § 1504(a)(3)(A) of the Code barring a corporation from filing a consolidated return with a group of which it had ceased to be a member for 60 months following the year of disaffiliation. The procedure clarifies and supersedes Rev. Proc. 91–71 (1991–2 C.B. 900). See Rev. Proc. 2002–32, page 959.

Section 4940.—Excise Tax Based on Investment Income

Responsibilities of a private foundation relating to § 507, chapter 42 (§§ 4940–4945) and tax return filing obligations (§§ 6033 and 6043) when it transfers all of its assets to one or more effectively controlled private foundations. See Rev. Rul. 2002–28, page 941.

Section 4941.—Taxes on Self-Dealing

Responsibilities of a private foundation relating to § 507, chapter 42 (§§ 4940–4945) and tax return filing obligations (§§ 6033 and 6043) when it transfers all of its assets to one or more effectively controlled private foundations. See Rev. Rul. 2002–28, page 941.

Section 4942.—Taxes on Failure to Distribute Income

Responsibilities of a private foundation relating to § 507, chapter 42 (§§ 4940–4945) and tax return filing obligations (§§ 6033 and 6043) when it transfers all of its assets to one or more effectively controlled private foundations. See Rev. Rul. 2002–28, page 941.

Section 4943.—Taxes on Excess Business Holdings

Responsibilities of a private foundation relating to § 507, chapter 42 (§§ 4940–4945) and tax return filing obligations (§§ 6033 and 6043) when it transfers all of its assets to one or more effectively controlled private foundations. See Rev. Rul. 2002–28, page 941.

Section 4944.—Taxes on Investments Which Jeopardize Charitable Purpose

Responsibilities of a private foundation relating to § 507, chapter 42 (§§ 4940–4945) and tax return filing obligations (§§ 6033 and 6043) when it transfers all of its assets to one or more effectively controlled private foundations. See Rev. Rul. 2002–28, page 941.

Section 4945.—Taxes on Taxable Expenditures

Responsibilities of a private foundation relating to § 507, chapter 42 (§§ 4940–4945) and tax return filing obligations (§§ 6033 and 6043) when it transfers all of its assets to one or more effectively controlled private foundations. See Rev. Rul. 2002–28, page 941.

Section 6033.—Returns by Exempt Organizations

Responsibilities of a private foundation relating to § 507, chapter 42 (§§ 4940–4945) and tax return filing obligations (§§ 6033 and 6043) when it transfers all of its assets to one or more effectively controlled private foundations. See Rev. Rul. 2002–28, page 941.

Section 6043.—Liquidating, etc., Transactions

Responsibilities of a private foundation relating to § 507, chapter 42 (§§ 4940–4945) and tax return filing obligations (§§ 6033 and 6043) when it transfers all of its assets to one or more effectively controlled private foundations. See Rev. Rul. 2002–28, page 941.

Section 6501.—Limitations on Assessment and Collection

Ct. D. 2074

SUPREME COURT OF THE UNITED STATES

No. 00–1567

YOUNG, ET UX., *v.* UNITED STATES

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

March 4, 2002

Syllabus

If the Internal Revenue Service (IRS) has a claim for certain taxes for which the return was due within three years before the individual taxpayer files a bankruptcy petition, its claim enjoys eighth priority under 11 U.S.C. Sec. 507(a)(8)(A)(i), and is nondischargeable in bankruptcy under Sec. 523(a)(1)(A). The IRS assessed a tax liability against petitioners for their failure to include payment with their 1992 income tax return filed on October 15, 1993. On May 1, 1996, petitioners filed a Chapter 13 bankruptcy petition, which they moved to dismiss before a reorganization plan was approved. On March 12, 1997, the day before the Bankruptcy Court dismissed the Chapter 13 petition, petitioners filed a Chapter 7 petition. A discharge was granted, and the case was closed. When the IRS subsequently demanded that they pay the tax debt, petitioners asked the Bankruptcy Court to reopen the Chapter 7 case and declare the debt discharged under Sec. 523(a)(1)(A), claiming that it fell outside Sec. 507(a)(8)(A)(i)'s "three-year lookback period" because it pertained to a tax return due more than three years before their Chapter 7 filing. The court reopened the case, but sided with the IRS. Petitioners' tax return was due more than three years before their Chapter 7 filing but less than three years before their Chapter 13 filing. Holding that the "lookback period" is tolled during the pendency of a prior bankruptcy petition, the court concluded that the 1992 debt had not been discharged when petitioners were granted a discharge under Chapter 7. The District Court and the First Circuit agreed.

Held: Section 507(a)(8)(A)(i)'s lookback period is tolled during the pendency of a prior bankruptcy petition. Pp. 3–11.

(a) The lookback period is a limitations period subject to traditional equitable tolling principles. It prescribes a period in which certain rights may be enforced, encouraging the IRS to protect its rights before three years have elapsed. Thus, it serves the same basic policies furthered by all limitations periods: "repose, elimination of stale claims, and certainty about a plaintiff's opportunity

for recovery and a defendant's potential liabilities." *Rotella v. Wood*, 528 U.S. 549, 555. The fact that the lookback commences on a date that may precede the date when the IRS discovers its claim does not make it a substantive component of the Bankruptcy Code as petitioners claim. Pp. 2–6.

(b) Congress is presumed to draft limitations periods in light of the principle that such periods are customarily subject to equitable tolling unless tolling would be inconsistent with statutory text. Tolling is appropriate here. Petitioners' Chapter 13 petition erected an automatic stay under Sec. 362(a), which prevented the IRS from taking steps to collect the unpaid taxes. When petitioners later filed their Chapter 7 petition, the three-year lookback period therefore excluded time during which their Chapter 13 petition was pending. Because their 1992 tax return was due within that three-year period, the lower courts properly held that the tax debt was not discharged. Tolling is appropriate regardless of whether petitioners filed their Chapter 13 petition in good faith or solely to run down the lookback period. In either case, the IRS was disabled from protecting its claim. Pp. 6–8

(c) The statutory provisions invoked by petitioners — Secs. 523(b), 108(c), and 507(a)(8)(A)(ii) — do not display an intent to preclude tolling here. Pp. 8–10.

233 F.3d 56, affirmed.

SCALIA, J., delivered the opinion for a unanimous Court.

SUPREME COURT OF THE UNITED STATES

No. 00–1567

CORNELIUS P. YOUNG, ET UX., PETITIONERS *v.* UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

March 4, 2002

JUSTICE SCALIA delivered the opinion of the Court.

A discharge under the Bankruptcy Code does not extinguish certain tax liabilities for which a return was due within three years before the filing of an individual debtor's petition. 11 U.S.C. Sec. 523(a)(1)(A), 507(a)(8)(A)(i). We must decide whether this "three-year lookback period" is tolled during the pendency of a prior bankruptcy petition.

I

Petitioners Cornelius and Suzanne Young failed to include payment with their 1992 income tax return, due and filed on October 15, 1993 (petitioners had obtained an extension of the April 15 deadline). About $15,000 was owing. The Internal Revenue Service (IRS) assessed the tax liability on January 3, 1994, and petitioners made modest monthly payments ($40 to $300) from April 1994 until November 1995. On May 1, 1996, they sought protection under Chapter 13 of the Bankruptcy Code in the United States Bankruptcy Court for the District of New Hampshire. The bulk of their tax liability (about $13,000, including accrued interest) remained due. Before a reorganization plan was confirmed, however, the Youngs moved on October 23, 1996, to dismiss their Chapter 13 petition, pursuant to 11 U.S.C. Sec. 1307(b). On March 12, 1997, one day before the Bankruptcy Court dismissed their Chapter 13 petition, the Youngs filed a new petition, this time under Chapter 7. This was a "no asset" petition, meaning that the Youngs had no assets available to satisfy unsecured creditors, including the IRS. A discharge was granted June 17, 1997; the case was closed September 22, 1997.

The IRS subsequently demanded payment of the 1992 tax debt. The Youngs refused, and petitioned the Bankruptcy Court to reopen their Chapter 7 case and declare the debt discharged. In their view, the debt fell outside the Bankruptcy Code's "three-year lookback period," Secs. 523(a)(1)(A), 507(a)(8)(A)(i), and had therefore been discharged, because it pertained to a tax return due on October 15, 1993, more than three years before their Chapter 7 filing on March 12, 1997. The Bankruptcy Court reopened the case, but sided with the IRS. Although the Youngs' 1992 income tax return was due more than three years before they filed their Chapter 7 petition, it was due less than three years before they filed their Chapter 13 petition on May 1, 1996. Holding that the "three-year lookback period" is tolled during the pendency of a prior bankruptcy petition, the Bankruptcy Court concluded that the 1992 tax debt had not been discharged. The District Court for the District of New Hampshire and Court of Appeals for the First Circuit agreed. 233 F.3d 56 (2000). We granted certiorari. 533 U.S. 976 (2001).

II

Section 523(a) of the Bankruptcy Code excepts certain individual debts from discharge, including any tax "of the kind and for the periods specified in section . . . 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed." Sec. 523(a)(1)(A). Section 507(a), in turn, describes the priority of certain claims in the distribution of the debtor's assets. Subsection 507(a)(8)(A)(i) gives eighth priority to "allowed unsecured claims of governmental units, only to the extent that such claims are for — . . . a tax on or measured by income or gross receipts — . . . *for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition. . . .*" (Emphasis added.) This is commonly known as the "three-year lookback period." If the IRS has a claim for taxes for which the return was due within three years before the bankruptcy petition was filed, the claim enjoys eighth priority under Sec. 507(a)(8)(A)(i) and is nondischargeable in bankruptcy under Sec. 523(a)(1)(A).

The terms of the lookback period appear to create a loophole: Since the Code does not prohibit back-to-back Chapter 13 and Chapter 7 filings (as long as the debtor did not receive a discharge under Chapter 13, see Secs. 727(a)(8), (9)), a debtor can render a tax debt dischargeable by first filing a Chapter 13 petition, then voluntarily dismissing the petition when the lookback period for the debt has lapsed, and finally refiling under Chapter 7. During the pendency of the Chapter 13 petition, the automatic stay of Sec. 362(a) will prevent the IRS from taking steps to collect the unpaid taxes, and if the Chapter 7 petition is filed after the lookback period has expired, the taxes remaining due will be dischargeable. Petitioners took advantage of this loophole, which, they believe, is permitted by the Bankruptcy Code.

We disagree. The three-year lookback period is a limitations period subject to traditional principles of equitable tolling.

Since nothing in the Bankruptcy Code precludes equitable tolling of the lookback period, we believe the courts below properly excluded from the three-year limitation the period during which the Youngs' Chapter 13 petition was pending.

A

The lookback period is a limitations period because it prescribes a period within which certain rights (namely, priority and nondischargeability in bankruptcy) may be enforced. 1 H. Wood, Limitations of Actions Sec. 1, p. 1 (4th D. Moore ed. 1916). Old tax claims — those pertaining to returns due more than three years before the debtor filed the bankruptcy petition — become dischargeable, so that a bankruptcy decree will relieve the debtor of the obligation to pay. The period thus encourages the IRS to protect its rights — by, say, collecting the debt, 26 U.S.C. Secs. 6501, 6502 (1994 ed. and Supp. V), or perfecting a tax lien, Secs. 6322, 6323(a), (f) (1994 ed.) — before three years have elapsed. If the IRS sleeps on its rights, its claim loses priority and the debt becomes dischargeable. Thus, as petitioners concede, the lookback period serves the same "basic policies [furthered by] all limitations provisions: repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities. *Rotella v. Wood*, 528 U.S. 549, 555 (2000). It is true that, unlike most statutes of limitations, the lookback period bars only *some*, and not *all* legal remedies[1] for enforcing the claim (viz., priority and nondischargeability in bankruptcy); that makes it a more limited statute of limitations, but a statute of limitations nonetheless.

Petitioners argue that the lookback period is a substantive component of the Bankruptcy Code, not a procedural limitations period. The lookback period commences on the date the return for the tax debt "is last due," Sec. 507(a)(8)(A)(i), not on the date the IRS discovers or assesses the unpaid tax. Thus, the IRS may have less than three years to protect itself against the risk that a debt will become dischargeable in bankruptcy.

To illustrate, petitioners offer the following variation on this case: Suppose the Youngs filed their 1992 tax return on October 15, 1993, but had not received (as they received here) an extension of the April 15, 1993, due date. Assume the remaining facts of the case are unchanged: The IRS assessed the tax on January 3, 1994; petitioners filed a Chapter 13 petition on May 1, 1996; that petition was voluntarily dismissed and the Youngs filed a new petition under Chapter 7 on March 12, 1997. In this hypothetical, petitioners argue, their tax debt would have been dischargeable in the *first* petition under Chapter 13. Over three years would have elapsed between the due date of their return (April 15, 1993) and their Chapter 13 petition (May 1, 1996). But the IRS — which may not have discovered the debt until petitioners filed a return on October 15, 1993 — would have enjoyed less than three years to collect the debt or prevent the debt from becoming dischargeable in bankruptcy (by perfecting a tax lien). The Code even contemplates this possibility, petitioners believe. Section 523(a)(1)(B)(ii) renders a tax debt nondischargeable if it arises from an untimely return filed within *two years* before a bankruptcy petition. Thus, if petitioners had filed their return on April 30, 1994 (more than two years before their Chapter 13 petition), and if the IRS had been unaware of the debt until the return was filed, the IRS would have had only *two years* to act before the debt became dischargeable in bankruptcy. For these reasons, petitioners believe the lookback period is not a limitations period, but rather a *definition* of dischargeable taxes.

We disagree. In the sense in which petitioners use the term, *all* limitations periods are "substantive": They *define* a subset of claims eligible for certain remedies. And the lookback is not distinctively "substantive" merely because it commences on a date that may precede the date when the IRS discovers its claim. There is nothing unusual about a statute of limitations that commences when the claimant has a complete and present cause of action, whether or not he is aware of it. See 1 C. Corman, Limitation of Actions Sec. 6.1, Pp. 370, 378 (1991); 2 Wood, *supra*, Sec. 276c(1) at 1411. As for petitioners' reliance on Sec. 523(a)(1)(B)(ii), that section proves, at most, that Congress put different limitations periods on different kinds of tax debts. All tax debts falling within the terms of the three-year lookback period are nondischargeable in bankruptcy. Secs. 523(a)(1)(A), 507(a)(8)(A)(i). Even if a tax debt falls outside the terms of the lookback period, it is nonetheless nondischargeable if it pertains to an untimely return filed within two years before the bankruptcy petition. Sec. 523(a)(1)(B)(ii). These provisions are complementary; they do not suggest that the lookback period is something other than a limitations period.

B

It is hornbook law that limitations periods are "customarily subject to 'equitable tolling,'" *Irwin v. Department of Veterans Affairs*, 498 U.S. 89, 95 (1990), unless tolling would be "inconsistent with the text of the relevant statute," *United States v. Beggerly*, 524 U.S. 38, 48 (1998). See also *American Pipe & Constr. Co. v. Utah*, 414 U.S. 538, 558–559 (1974); *Holmberg v. Armbrecht*, 327 U.S. 392, 397 (1946); *Bailey v. Glover*, 21 Wall. 342, 349–350 (1875). Congress must be presumed to draft limitations periods in light of this background principle. Cf. *National Private Truck Council, Inc. v. Oklahoma Tax Comm'n*, 515 U.S. 582, 589–590 (1995); *United States v. Shabani*, 513 U.S. 10, 13 (1994). That is doubly true when it is enacting limitations periods to be applied by bankruptcy courts, which are courts of equity and "appl[y] the principles and rules of equity jurisprudence." *Pepper v. Litton*, 308 U.S. 295, 304 (1939); see also *United States v. Energy Resources Co.*, 495 U.S. 545, 549 (1990).

This Court has permitted equitable tolling in situations "where the claimant

[1]Equitable remedies may still be available. Traditionally, for example, a mortgagee could sue in equity to foreclose mortgaged property even though the underlying debt was time barred. *Hardin v. Boyd*, 113 U.S. 756, 765–766 (1885); 2 G. Glenn, Mortgages Secs. 141–142, pp. 812–818 (1943); see also *Beach v. Ocwen Fed. Bank*, 523 U.S. 410, 415–416 (1998) (recoupment is available after a limitations period has lapsed); *United States v. Dalm*, 494 U.S. 596, 611 (1990) (same).

has actively pursued his judicial remedies by filing a defective pleading during the statutory period, or where the complainant has been induced or tricked by his adversary's misconduct into allowing the filing deadline to pass." *Irwin, supra*, at 96 (footnotes omitted). We have acknowledged, however, that tolling might be appropriate in other cases, see, *e.g., Baldwin County Welcome Center v. Brown*, 466 U.S. 147, 151 (1984) (*per curiam*), and this, we believe, is one. Cf. *Amy v. Watertown* (No. 2), 130 U.S. 320, 325–326 (1889); 3 J. Story, Equity Jurisprudence Sec. 1974, pp. 558–559 (14th W. Lyon ed. 1918). The Youngs' Chapter 13 petition erected an automatic stay under Sec. 362, which prevented the IRS from taking steps to protect its claim. When the Youngs filed a petition under Chapter 7, the three-year lookback period therefore excluded time during which their Chapter 13 petition was pending. The Youngs' 1992 tax return was due within that three-year period. Hence the lower courts properly held that the tax debt was not discharged when the Youngs were granted a discharge under Chapter 7.

Tolling is in our view appropriate regardless of petitioners' intentions when filing back-to-back Chapter 13 and Chapter 7 petitions — whether the Chapter 13 petition was filed in good faith or solely to run down the lookback period. In either case, the IRS was disabled from protecting its claim during the pendency of the Chapter 13 petition, and this period of disability tolled the three-year lookback period when the Youngs filed their Chapter 7 petition.

C

Petitioners invoke several statutory provisions which they claim display an intent to preclude tolling here. First they point to Sec. 523(b), which, they believe, explicitly permits discharge in a Chapter 7 proceeding of certain debts that were nondischargeable (as this tax debt was) in a prior Chapter 13 proceeding. Petitioners misread the provision. Section 523(b) declares that

> "a debt that was *excepted from discharge* under subsection (a)(1), (a)(3), or (a)(8) of this section . . . in a prior case concerning the debtor . . . is dischargeable in a case under this title unless, by the terms of subsection (a) of this section, such debt is not dischargeable in the case under this title." (Emphasis added.)

The phrase "excepted from discharge" in this provision is not synonymous (as petitioners would have it) with "nondischargeable." It envisions a prior bankruptcy proceeding that progressed *to the discharge stage*, from which discharge a particular debt was actually "excepted." It thus has no application to the present case; and even if it did, the very same arguments in favor of tolling that we have found persuasive with regard to Sec. 507 would apply to Sec. 523 as well. One might perhaps have expected an explicit tolling provision in Sec. 523(b) if that subsection applied *only* to those debts "excepted from discharge" in the earlier proceeding that were subject to the three-year lookback — but in fact it also applies to excepted debts (see Sec. 523(a)(3)) that were subject to no limitation period. And even the need for tolling as to debts that *were* subject to the three-year lookback is minimal, since a separate provision of the Code, Sec. 727(a)(9), constrains successive discharges under Chapters 13 and 7: Generally speaking, six years must elapse between filing of the two bankruptcy petitions, which would make the need for tolling of the three-year limitation nonexistent. The absence of an explicit tolling provision in Sec. 523 therefore suggests nothing.

Petitioners point to two provisions of the Code which, in their view, do contain a tolling provision. Its presence there, and its absence in Sec. 507, they argue, displays an intent to preclude equitable tolling of the lookback period. We disagree. Petitioners point first to Sec. 108(c), which reads:

> "Except as provided in section 524 of this title, if applicable nonbankruptcy law . . . fixes a period for commencing or continuing a civil action in a court other than a bankruptcy court on a claim against the debtor . . . , and such period has not expired before the date of the filing of the petition, then such period does not expire until the later of — (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or (2) 30 days after notice of the termination or expiration of the stay . . . with respect to such claim."

Petitioners believe Sec. 108(c)(1) contains a tolling provision. The lower courts have split over this issue, compare, *e.g., Rogers v. Corrosion Products, Inc.*, 42 F.3d 292, 297 (CA5), cert. denied, 515 U.S. 1160 (1995), with *Garbe Iron Works, Inc. v. Priester*, 99 Ill. 2d 84, 457 N.E.2d 422 (1983); we need not resolve it here. Even assuming petitioners are correct, we would draw no negative inference from the presence of an express tolling provision in Sec. 108(c)(1) and the absence of one in Sec. 507. It would be quite reasonable for Congress to instruct *nonbankruptcy* courts (including state courts) to toll *nonbankruptcy* limitations periods (including state law limitations periods) while at the same time, assuming that bankruptcy courts will use their inherent equitable powers to toll the federal limitations periods within the Code.

Finally, petitioners point to a tolling provision in Sec. 507(a)(8)(A), the same subsection that sets forth the three-year lookback period. Subsection 507(a)(8)(A) grants eighth priority to tax claims pertaining to returns that were *due* within the three-year lookback period, Sec. 507(a)(8)(A)(i), and to claims that were *assessed* within 240 days before the debtor's bankruptcy petition, Sec. 507(a)(8)(A)(ii). Whereas the three-year lookback period contains no express tolling provision, the 240-day lookback period is tolled "any time plus 30 days during which an offer in compromise with respect to such tax that was made within 240 days after such assessment was pending." Sec. 507(a)(8)(A)(ii). Petitioners believe this express tolling provision, appearing in the same subsection as the three-year lookback period, demonstrates a statutory intent *not* to toll the three-year lookback period.

If anything, Sec. 507(a)(8)(A)(ii) demonstrates that the Bankruptcy Code *incorporates* traditional equitable principles. An "offer in compromise" is a settlement offer submitted by a debtor. When Sec. 507(a)(8)(A)(ii) was enacted, it was IRS practice — though no statutory provision required it — to stay collection efforts (if the Government's interests would not be jeopardized) during the pendency of an "offer in compromise," 26 CFR Sec. 301.7122–1(d)(2) (1978); M. Saltzman,

IRS Practice and Procedure ¶ 15.07[1], p. 15–47 (1981).[2] Thus, a court would not have equitably tolled the 240-day lookback period during the pendency of an "offer in compromise," since tolling is inappropriate when a claimant has voluntarily chosen not to protect his rights within the imitations period. See, *e.g.*, *Irwin*, 498 U.S. at 96. Hence the tolling provision in Sec. 507(a)(8)(A)(ii) *supplements* rather than displaces, principles of equitable tolling.

* * * *

We conclude that the lookback period of 11 U.S.C. Sec. 507(a)(8)(A)(i) is tolled during the pendency of a prior bankruptcy petition. The judgment of the Court of Appeals for the First Circuit is affirmed.

It is so ordered.

[2] The Code was amended in 1998 to prohibit collection efforts during the pendency of an offer in compromise. See 26 U.S.C. Sec. 6331(k) (1994 ed., Supp. V).

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.201: Rulings and determination letters. (Also Part I §§ 1502, 1504; 1.1502–75, 1.1504–1.)

Rev. Proc. 2002–32

SECTION 1. PURPOSE

.01 This revenue procedure clarifies and supersedes Rev. Proc. 91–71 (1991–2 C.B. 900) which grants certain taxpayers a waiver of the general rule of § 1504 (a)(3)(A) of the Internal Revenue Code. Section 1504(a)(3)(A) generally provides that a corporation that ceased to be a member of a consolidated group (or a successor of such corporation) may not be included in any consolidated return filed by that affiliated group (or another affiliated group with the same common parent or a successor of such common parent) before the 61^{st} month beginning after the first taxable year in which such corporation ceased to be a member of such group.

.02 If (1) § 1504(a)(3)(A) applies to prevent the inclusion of a corporation in a consolidated return, and (2) the representations described in sections 5.03 and 5.14 of this revenue procedure can be made with respect to such corporation, then such corporation may be included in the consolidated return for the taxable year that includes the date on which § 1504(a)(3)(A) would first apply to prevent such corporation from being included in such consolidated return if, and only if, an automatic waiver of the general rule of § 1504(a)(3)(A) is obtained pursuant to section 5 of this revenue procedure.

.03 If (1) § 1504(a)(3)(A) applies to prevent the inclusion of a corporation in a consolidated return, and (2) the representations described in section 5.03 or 5.14 of this revenue procedure cannot be made with respect to such corporation, then a waiver of the application of the general rule of § 1504(a)(3)(A) for any taxable year may only be obtained in the form of a private letter ruling pursuant to section 7 of this revenue procedure.

.04 If (1) § 1504(a)(3)(A) applies to prevent the inclusion of a corporation in a consolidated return, (2) the representations described in sections 5.03 and 5.14 of this revenue procedure can be made with respect to such corporation, and (3) the procedures for obtaining an automatic waiver of the general rule of § 1504 (a)(3)(A) are not followed, then a waiver of the application of the general rule of § 1504(a)(3)(A) may be obtained only for taxable years other than the taxable year that includes the date on which § 1504(a)(3)(A) first applies to prevent such corporation from being included in a consolidated return and may only be obtained in the form of a private letter ruling pursuant to section 7 of this revenue procedure.

SECTION 2. BACKGROUND

.01 Section 1504(a)(3)(A) provides that (1) if a corporation is included (or required to be included) in a consolidated return filed by an affiliated group for a taxable year that includes any period after December 31, 1984, and (2) the corporation ceases to be a member of such affiliated group in a taxable year beginning after December 31, 1984, the corporation (and any successor of the corporation) may not be included in any consolidated return filed by such affiliated group (or by another affiliated group with the same common parent or a successor of the common parent) before the 61^{st} month beginning after its first taxable year in which it ceased to be a member of such affiliated group. Section 1504(a)(3)(B) provides that the Secretary may waive the application of § 1504(a)(3)(A) to any corporation for any period subject to such conditions as the Secretary may prescribe.

.02 For purposes of this revenue procedure, unless otherwise provided, a reference to a successor of a corporation includes each successor of a successor of such corporation, and a reference to a predecessor of a corporation includes each predecessor of a predecessor of such corporation.

SECTION 3. APPLICATION

.01 Any corporation described in section 4.01 of this revenue procedure that requests an automatic waiver by complying with the requirements set forth in section 5 of this revenue procedure is hereby granted a waiver under § 1504(a)(3)(B) so that the corporation may be included in the consolidated return filed (or required to be filed) by the affiliated group of which it is a member, as provided in section 6 of this revenue procedure. Any corporation described in section 4.01 of this revenue procedure that does not or cannot comply with the requirements set forth in section 5 may request a waiver of the application of the general rule of § 1504(a)(3)(A) pursuant to section 7 of this revenue procedure.

.02 If pursuant to section 4.02, 4.03, or 4.04 of this revenue procedure, § 1504(a)(3)(A) does not apply to prevent the inclusion in a consolidated return of a corporation, such corporation must be included in the consolidated return filed by the affiliated group of which it is a member. No waiver is necessary.

SECTION 4. SCOPE

.01 This revenue procedure applies to any corporation (a deconsolidated corporation) (1) that was included (or was required to be included), or whose predecessor was included (or was required to be included), in a consolidated return filed (or required to be filed) by an affiliated group (the original group), (2) that ceased, or whose predecessor ceased, to be a member of such original group, and (3) that subsequently became affiliated with that original group (or another affiliated group with the same common parent or a successor of such common parent) before the 61^{st} month beginning after the first taxable year in which it or its predecessor ceased to be a member of the original group.

.02 Except as provided in section 4.05, § 1504(a)(3)(A) does not apply to prevent the inclusion in a consolidated return of any corporation that was a member of a consolidated group (the terminating group) and that ceased to be a member of such group solely as a result of a transaction in which a nonmember corporation acquired the assets of the common parent of the terminating group in a reorganization described in § 368(a)(1)(A), (C), (D), or (G) (but, with respect to a reorganization described in § 368(a)(1)(D) or (G), only if the requirements of § 354(b)(1)(A) and (B) are met), and immediately after

the acquisition, the acquiring corporation is the common parent of another affiliated group (the acquiring group). If the acquiring group files a consolidated return, all members of the terminating group that are includible corporations must be included in the consolidated return. See Rev. Rul. 91–70 (1991–2 C.B. 361).

.03 Except as provided in section 4.05, § 1504(a)(3)(A) does not apply to prevent the inclusion in a consolidated return of any corporation that was a member of a consolidated group (the terminating group) and that ceased to be a member of such group solely as a result of a transaction in which a member of the terminating group acquired (a) the assets of a nonmember corporation in a reorganization described in § 368(a)(1)(A), (C), (D), or (G) (but, with respect to a reorganization described in § 368(a)(1)(D) or (G), only if the requirements of § 354(b)(1)(A) and (B) are met) or (b) the stock of a nonmember corporation, and the acquisition was a reverse acquisition described in § 1.1502–75(d)(3) of the Income Tax Regulations in which the terminating group ceased to exist. If the group that remains in existence files a consolidated return, all members of the terminating group that are includible corporations must be included in the consolidated return. See Rev. Rul. 91–70.

.04 Except as provided in section 4.05, § 1504(a)(3)(A) does not apply to prevent the inclusion in a consolidated return of any corporation that was a member of a consolidated group (the terminating group) and that ceased to be a member of the terminating group solely as a result of a transaction in which (1) a nonmember corporation (the acquiring corporation) acquired (a) the assets of the common parent of the terminating group in a reorganization described in § 368(a)(1)(A), (C), (D), or (G) (but, with respect to a reorganization described in § 368(a)(1)(D) or (G), only if the requirements of § 354(b)(1)(A) and (B) are met) or (b) stock of the common parent of the terminating group that satisfies the requirements of § 1504(a)(2), (2) immediately after such acquisition, the acquiring corporation is a member of another affiliated group (the acquiring group), and (3) subsequent to such acquisition, the common parent of the acquiring group or a successor of the common parent of the acquiring group acquires assets or stock of the former common parent of the terminating group or a successor of such former common parent. If the acquiring group files a consolidated return, the corporation must be included in the consolidated return, provided such corporation is an includible corporation. Cf. Rev. Rul. 91–70.

.05 If a corporation is described in section 4.02, 4.03, or 4.04, and such corporation (or such corporation's predecessor, as applicable) (1) was included (or was required to be included) in a consolidated return filed (or required to be filed) by an affiliated group other than the terminating group (a prior group), (2) ceased to be a member of such prior group, and (3) subsequently became affiliated with such prior group (or another affiliated group with the same common parent or a successor of the common parent of such prior group) before the 61st month beginning after the first taxable year in which it or its predecessor ceased to be a member of such group, § 1504(a)(3)(A) applies to prevent the inclusion of such corporation in a consolidated return of such prior group or another affiliated group with the same common parent or a successor of the common parent of such prior group. Accordingly, that corporation is treated as a deconsolidated corporation and must comply with the requirements set forth in section 5 of this revenue procedure (or if it cannot comply with section 5, section 7) to obtain a waiver of § 1504(a)(3)(A).

SECTION 5. PROCEDURE FOR A DECONSOLIDATED CORPORATION TO REQUEST AN AUTOMATIC WAIVER UNDER SECTION 1504(a)(3)(B)

To obtain an automatic waiver of § 1504(a)(3)(A), the deconsolidated corporation must be included in a timely-filed consolidated return (including extensions) of the affiliated group with respect to which the waiver request relates (the current group), for the taxable year that includes the date on which such corporation most recently became a member of such affiliated group. In addition, a statement, filed under penalties of perjury, that includes the information described in sections 5.01 through 5.14 of this revenue procedure, which is subject to verification on examination, as provided by section 6.02 of this revenue procedure, must be attached to such return.

.01 The following heading typed or legibly printed at the top of the statement: "AUTOMATIC WAIVER OF THE APPLICATION OF SECTION 1504(a)(3) FILED PURSUANT TO REV. PROC. 2002–32."

.02 The name, address, and employer identification number of the deconsolidated corporation, and the name, address, and employer identification number of each corporation, if any, that was a predecessor of such deconsolidated corporation at any time on or after the date a predecessor of such deconsolidated corporation ceased to be a member of the current group (or another affiliated group with the same common parent or a predecessor of the common parent of the current group).

.03 If the common parent of the current group is the common parent of the group from which the deconsolidated corporation or its predecessor disaffiliated (the former group), a representation that such common parent was not an S corporation, an entity disregarded as an entity separate from its owner, a real estate investment trust, or a regulated investment company at any time during the period of disaffiliation. If the common parent of the current group was not the common parent of the former group, a representation that the common parent of the former group and each successor of the common parent of the former group was not an S corporation, an entity disregarded as an entity separate from its owner, a real estate investment trust, or a regulated investment company at any time during the period beginning on the date of disaffiliation and ending on the date that such common parent or successor ceased to exist. In addition, if the common parent of the current group was not the common parent of the former group, a representation that the common parent of the current group was not an S corporation, an entity disregarded as an entity separate from its owner, a real estate investment trust, or a regulated investment company at any time during the period beginning on the date that such

corporation became a successor of the common parent of the former group and ending on the date the deconsolidated corporation became a member of the current group.

.04 The year in which the current group elected to file consolidated returns.

.05 The date on which the deconsolidated corporation or its predecessor ceased to be a member of either the current group or the former group.

.06 The date on which the deconsolidated corporation most recently became a member of the current group.

.07 A description of the manner by which the deconsolidated corporation or its predecessor ceased to be a member of the current group or the former group and the manner by which the deconsolidated corporation became a member of the current group (redemption of stock, new issuance of stock, etc.). This statement should include the business purposes of the transactions that caused the disaffiliation and subsequent affiliation and describe whether the transactions were with a related party.

.08 If the common parent of the current group is the common parent of the former group and the former group remained in existence throughout the period of disaffiliation, the taxable income of the current group for (1) the taxable year prior to the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of the current group, (2) the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of such group, (3) each taxable year subsequent to the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of such group but before the deconsolidated corporation again became a member of the current group, and (4) the taxable year in which the deconsolidated corporation became a member of the current group.

.09 If the common parent of the current group is the common parent of the former group and the former group ceased to exist on or after the date on which the deconsolidated corporation or its predecessor ceased to be a member of the former group and before the date the deconsolidated corporation became a member of the current group, the taxable income of the former group for (1) the taxable year prior to the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of the former group, (2) the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of such group, and (3) each taxable year, if any, subsequent to the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of such group and during which such group existed. In addition, (1) the taxable income of the common parent of the former group or its successor for each interim taxable year (as defined herein) during which such common parent of the former group was not the common parent of a consolidated group, (2) the taxable income of any consolidated group other than the former group of which the common parent of the former group or its successor was the common parent during any interim taxable year for each interim taxable year, and (3) the taxable income of the current group for the taxable year in which the deconsolidated corporation became a member of the current group. For purposes of this section 5.09 and sections 5.10 and 5.11 of this revenue procedure, the term interim taxable year refers to any taxable year that is subsequent to the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of the former group but before the taxable year in which the deconsolidated corporation became a member of the current group.

.10 If the common parent of the current group is not the common parent of the former group, the taxable income of the former group for (1) the taxable year prior to the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of the former group, (2) the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of such group, and (3) each interim taxable year, if any, during which such group existed. In addition, (1) the taxable income of the common parent of the former group or its successor for each interim taxable year during which such common parent of the former group or its successor was not the common parent of a consolidated group, (2) the taxable income of any consolidated group other than the former group of which the common parent of the former group or its successor was the common parent during any interim taxable year for each interim taxable year, and (3) the taxable income of the current group for the taxable year in which the deconsolidated corporation became a member of the current group.

.11 The taxable income, or separate taxable income (adjusted for the items that would be taken into account in determining the consolidated net operating loss attributable to the deconsolidated corporation under § 1.1502–21(b)(2)(iv)), as the case may be, of the deconsolidated corporation or its predecessor, as applicable, for (1) the taxable year prior to the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of the current group or the former group, (2) the taxable year in which the deconsolidated corporation or its predecessor ceased to be a member of such group, (3) each interim taxable year, and (4) the taxable year in which the deconsolidated corporation became a member of the current group.

.12 An analysis of the effect of the disaffiliation and the effect of the subsequent consolidation on the following items of (a) the deconsolidated corporation and its predecessor, as applicable, (b) the current group, and (c) if the current group is not the group from which the deconsolidated corporation or its predecessor disaffiliated, the former group or, if the former group terminated as a result of the disaffiliation or during the period of the disaffiliation, the common parent of the former group and the members of the former group (or their successors, if applicable) with which such common parent (or its successor, as applicable) was affiliated at any time during the period of disaffiliation for all periods described in section 5.11 of this revenue procedure:

(1) Taxable income;

(2) Gains and losses on intercompany transactions;

(3) Excess loss accounts;

(4) Tax liability;

(5) Net operating loss carryovers;

(6) Capital loss carryovers;

(7) Tax credits; and

(8) Losses deferred pursuant to § 267 (f).

.13 In the case of a consolidated group of which one or more members are reporting corporations described in

§ 6038A(a), an analysis of the effect of the disaffiliation and the effect of the subsequent consolidation on the United States taxation of any related party within the meaning of § 6038A(c)(2) (other than a member of the group). Such analysis must take into account any transfers of money or property occurring during the period of disaffiliation and involving (directly or indirectly) the deconsolidated corporation, its predecessors, and any reporting corporation or related party, if such transfers are not in the ordinary course of business.

.14 A representation that the disaffiliation and subsequent consolidation has not provided and will not provide a benefit of a reduction in income, increase in loss, or any other deduction, credit, or allowance (a federal tax savings) that would not otherwise be secured or have been secured had the disaffiliation and subsequent consolidation not occurred, including, but not limited to, the use of a net operating loss or credit that would have otherwise expired, or the use of a loss recognized on a disposition of stock of the deconsolidated corporation or a predecessor of such corporation. In determining whether the disaffiliation and subsequent consolidation provided or will provide a federal tax savings, the net tax consequences to all parties, taking into account the time value of money, are considered.

SECTION 6. EFFECT OF WAIVER

.01 A waiver under § 1504(a)(3)(B) granted pursuant to section 3.01 of this revenue procedure is binding on the consolidated group that files the statement required by section 5 of this revenue procedure with a consolidated return and may not be revoked by such consolidated group. The waiver is binding as of the date on which the deconsolidated corporation most recently became a member of the current group and as long as the deconsolidated corporation or a successor of such corporation remains a member of the current group or another group with a common parent that is a successor of the common parent of the current group, unless permission is granted for the entire group to cease filing a consolidated return.

.02 Notwithstanding section 6.01, if the Service determines that the information provided pursuant to section 5 of this revenue procedure was incorrect in any material respect at the time the waiver request was filed, the Service may revoke the waiver granted pursuant to this revenue procedure at any time, for all or any part of the period for which it was granted.

SECTION 7. DECONSOLIDATED CORPORATIONS THAT DO NOT QUALIFY FOR THE AUTOMATIC WAIVER

If a deconsolidated corporation cannot qualify for an automatic waiver pursuant to section 3.01 of this revenue procedure, a waiver under § 1504(a)(3)(B) may only be obtained through a letter ruling request filed in accordance with Rev. Proc. 2002–1 (2002–1 I.R.B. 1) (or similar revenue procedure applicable to a later year). If the representations described in sections 5.03 and 5.14 of this revenue procedure can be made with respect to such corporation and the procedures for obtaining an automatic waiver of the general rule of § 1504(a)(3)(A) are not followed, however, then a private letter ruling can only be obtained to waive the application of the general rule of § 1504(a)(3)(A) for taxable years other than the taxable year that includes the date on which § 1504(a)(3)(A) first applies to prevent such corporation from being included in the consolidated return. The letter ruling request must be submitted by the common parent of the affiliated group of which the deconsolidated corporation becomes a member before the due date (including extensions) of the consolidated return for the tax year with respect to which the waiver is requested. The letter ruling request must include the information set forth in section 5 of this revenue procedure. To the extent that the representations set forth in section 5.03 or section 5.14 of this revenue procedure cannot be made, however, the letter ruling request must: (1) contain information establishing that federal tax savings (as described in section 5.14 of this revenue procedure) was not a purpose of the disaffiliation, and that the amount of any federal tax savings attributable to the disaffiliation or a subsequent consolidation is not significant; and (2) state whether the deconsolidated corporation or a predecessor of such corporation was, at any time during the period of disaffiliation, in the effective control of any member (or successor of any member) of the current group or the former group.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 91–71 (1991–2 C.B. 900) is clarified, and, as clarified, is superseded.

SECTION 9. EFFECTIVE DATE

This revenue procedure is generally effective for consolidated returns due (including extensions) on or after May 20, 2002. Section 7 of this revenue procedure, however, applies to all letter ruling requests postmarked, or if not mailed, received, after May 20, 2002. Nonetheless, the Service may ask the taxpayer to submit information specified in this revenue procedure for any ruling requests postmarked, or if not mailed, received, before that date.

SECTION 10. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1784.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are in section 5 and section 7. This information is required to determine whether a taxpayer qualifies for a waiver under this revenue procedure. The collections of information are required to obtain a benefit. The likely respondents are corporations that were formerly members of consolidated groups and that later join affiliated groups.

The estimated total annual reporting burden is 100 hours.

The estimated annual burden per respondent varies from 2 hours to 8 hours, depending on individual circumstances, with an estimated average of 5 hours. The estimated number of respondents is 20.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue tax law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 11. DRAFTING INFORMATION

The principal author of this revenue procedure is Vincent Daly of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue procedure, contact Mr. Daly at (202) 622–7770 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, §§ 56, 168, 179, 446, 1400L.)

Rev. Proc. 2002–33

SECTION 1. PURPOSE

This revenue procedure provides procedures for a taxpayer to claim the additional 30 percent depreciation (additional first year depreciation) provided by §§ 168(k) and 1400L(b) of the Internal Revenue Code and other deductions for qualified property or qualified New York Liberty Zone (Liberty Zone) property that the taxpayer did not claim on the taxpayer's federal tax return filed before June 1, 2002. This revenue procedure also explains how a taxpayer may elect not to deduct the additional first year depreciation for qualified property and Liberty Zone property.

SECTION 2. BACKGROUND

.01 Section 168(k), as added by § 101 of the Job Creation and Worker Assistance Act of 2002 (the Act), Pub. L. No. 107–147, 116 Stat. 21 (March 9, 2002), and § 1400L(b), as added by § 301(a) of the Act, generally allow an additional first year depreciation deduction for qualified property or Liberty Zone property placed in service by the taxpayer after September 10, 2001. The term "qualified property" is defined in § 168(k)(2) and the term "Liberty Zone property" is defined in § 1400L(b)(2). The additional first year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the qualified property or Liberty Zone property is placed in service. If the property is described in both § 168(k) and § 1400L(b), only one additional first year depreciation deduction is allowable for the property.

.02 The additional first year depreciation deduction generally is determined without any proration based on the length of the taxable year in which the qualified property or Liberty Zone property is placed in service. The additional first year depreciation is equal to 30 percent of the adjusted basis of the qualified property or Liberty Zone property. The adjusted basis of this property generally is its cost or other basis multiplied by the percentage of business/investment use, reduced by the amount of any § 179 expense deduction and adjusted to the extent provided by other provisions of the Code and the regulations thereunder (for example, reduced by the amount of the disabled access credit pursuant to § 44(d)(7)).

.03 Before computing the amount otherwise allowable as a depreciation deduction for the placed-in-service year and subsequent taxable years, the adjusted basis of the qualified property or Liberty Zone property for which the additional first year depreciation is deductible must be reduced by the amount of the additional first year depreciation deduction. The remaining adjusted basis of this property is depreciated using the applicable depreciation provisions under the Code for the property (that is, § 167(f)(1) for computer software and § 168 for other property). This depreciation deduction for the remaining adjusted basis of the qualified property or Liberty Zone property for which the additional first year depreciation is deductible is allowed for both regular tax and alternative minimum tax purposes.

.04 The additional first year depreciation must not be deducted for, among other things: (1) property that is required to be depreciated under the alternative depreciation system of § 168(g) pursuant to § 168(g)(1)(A) through (D) or other provisions of the Code (for example, property described in § 263A(e)(2)(A) or § 280F(b)(1)); (2) property described in § 168(f); or (3) any class of property for which the taxpayer elects not to deduct the additional first year depreciation (see section 3 of this revenue procedure for further details about this election).

.05 Pursuant to §§ 168(k)(2)(C)(ii) and 1400L(b)(2)(C)(iii), Liberty Zone leasehold improvement property (as defined in § 1400L(c)(2)) is not eligible for the additional first year depreciation deduction. However, in accordance with § 1400L(c), this property is included as 5-year property for purposes of § 168. The straight-line method of depreciation is required to be used under § 168 for Liberty Zone leasehold improvement property and the class life for this property for purposes of the alternative depreciation system of § 168(g) is 9 years.

.06 For § 179 property that is Liberty Zone property, § 1400L(f) increased the amount a taxpayer may elect to expense under § 179 by the lesser of (1) $35,000, or (2) the cost of § 179 property that is Liberty Zone property placed in service during the taxable year. Accordingly, the § 179 expense deduction that may be elected for § 179 property that is Liberty Zone property placed in service by the taxpayer after September 10, 2001, is increased (1) to a maximum of $55,000 for a taxable year that began in 2000, and (2) to a maximum of $59,000 for a taxable year that began in 2001.

SECTION 3. ELECTION NOT TO DEDUCT ADDITIONAL FIRST YEAR DEPRECIATION

.01 *In General.* Pursuant to §§ 168(k)(2)(C)(iii) and 1400L(b)(2)(C)(iv), a taxpayer may make an election not to deduct the additional first year depreciation for any class of property placed in service during the taxable year. If the taxpayer makes this election, it applies to all qualified property or Liberty Zone property that is in the same class and placed in service in the same taxable year. In addition, the depreciation adjustments under § 56 apply to that property for purposes of computing the taxpayer's alternative minimum taxable income. The election not to deduct the additional first year depreciation for any class of property placed in service during the taxable year is made separately by each person owning

qualified property or Liberty Zone property (for example, by each member of a consolidated group, by the partnership, or by the S corporation).

.02 *Definition of Class of Property.*

(1) For purposes of the election under § 168(k)(2)(C)(iii) not to deduct the additional first year depreciation for qualified property, the term "class of property" means: (a) except for the property described in this section 3.02(1)(b) and (d), each class of property described in § 168(e) (for example, 5-year property); (b) water utility property as defined in § 168(e)(5) and depreciated under § 168; (c) computer software depreciated under § 167(f)(1); or (d) qualified leasehold improvement property as defined in § 168(k)(3) and depreciated under § 168.

(2) For purposes of the election under § 1400L(b)(2)(C)(iv) not to deduct the additional first year depreciation for Liberty Zone property, the term "class of property" means: (a) except for the property described in this section 3.02(2)(b), (d), and (e), each class of property described in § 168(e) (for example, 5-year property); (b) water utility property as defined in § 168(e)(5) and depreciated under § 168; (c) computer software depreciated under § 167(f)(1); (d) nonresidential real property described in § 1400L(b)(2)(B) and depreciated under § 168; or (e) residential rental property described in § 1400L(b)(2)(B) and depreciated under § 168.

.03 *Time and Manner of Making the Election.*

(1) *In general.* An election not to deduct the additional first year depreciation for any class of property that is qualified property or Liberty Zone property placed in service during the taxable year must be made by the due date (including extensions) of the federal tax return for the taxable year in which the qualified property or Liberty Zone property is placed in service by the taxpayer. The election must be made in the manner prescribed on Form 4562, *Depreciation and Amortization*, and its instructions. However, see section 3.03(3) of this revenue procedure for the procedures for making the election not to deduct the additional first year depreciation for any class of property placed in service by the taxpayer after September 10, 2001, during the taxable year beginning in 2000 or 2001 (2000 or 2001 taxable year).

(2) *Limited relief for late election.*

(a) *Automatic 6-month extension.* Pursuant to § 301.9100–2(b) of the Procedure and Administration Regulations, an automatic extension of 6 months from the due date of the federal tax return (*excluding* extensions) for the placed-in-service year of the qualified property or Liberty Zone property is granted to make the election not to deduct the additional first year depreciation, provided the taxpayer timely filed the taxpayer's federal tax return for the placed-in-service year and the taxpayer satisfies the requirements in § 301.9100–2(c) and § 301.9100–2(d).

(b) *Other extensions.* A taxpayer that fails to make the election not to deduct the additional first year depreciation for the placed-in-service year for the qualified property or Liberty Zone property as provided in section 3.03(1), 3.03(2)(a), 3.03(3), or 4.02 of this revenue procedure but wants to do so must file a request for an extension of time to make the election under the rules in § 301.9100–3.

(3) *Special rules for 2000 or 2001 return.*

(a) *Return filed on or after June 1, 2002.* If a taxpayer files the 2000 or 2001 federal tax return on or after June 1, 2002, the procedures in section 3.03(1) of this revenue procedure apply for making the election not to deduct the additional first year depreciation for any class of property that is qualified property or Liberty Zone property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year. However, the taxpayer must follow the instructions for the 2001 Form 4562 (Rev. March 2002). These instructions require the taxpayer to attach to the federal tax return a statement indicating the class of property for which the taxpayer is electing not to deduct the additional first year depreciation.

(b) *Return filed before June 1, 2002.* If a taxpayer has filed the 2000 or 2001 federal tax return before June 1, 2002, see section 4.02 of this revenue procedure for the procedures for making the election not to deduct the additional first year depreciation for any class of property that is qualified property or Liberty Zone property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year.

.04 *Revocation.* An election not to deduct the additional first year depreciation for a class of property that is qualified property or Liberty Zone property placed in service during the taxable year is revocable only with the prior written consent of the Commissioner of Internal Revenue. To seek the Commissioner's consent, the taxpayer must submit a request for a letter ruling in accordance with the provisions of Rev. Proc. 2002–1 (2002–1 I.R.B. 1) (or any successor).

.05 *Failure to make election not to deduct additional first year depreciation.* If a taxpayer does not make the election not to deduct the additional first year depreciation for a class of property that is qualified property or Liberty Zone property within the time and in the manner prescribed in section 3.03 or 4.02 of this revenue procedure, the amount of depreciation allowable for that property under § 167(f)(1) or under § 168, as applicable, must be determined for the placed-in-service year and for all subsequent years by taking into account the additional first year depreciation deduction. Thus, the election not to deduct the additional first year depreciation cannot be made by the taxpayer in any other manner (for example, through a request under § 446(e) to change the taxpayer's method of accounting).

SECTION 4. PROCEDURES FOR RETURNS FILED BEFORE JUNE 1, 2002

.01 *Additional First Year Depreciation.* If a taxpayer has filed a 2000 or 2001 federal tax return before June 1, 2002, and did not claim on that return the additional first year depreciation for a class of property that is qualified property or Liberty Zone property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year but wants to do so, the taxpayer may claim the additional first year depreciation for that class of property under this section 4.01, provided the taxpayer did not make an election not to deduct the additional first year depreciation for the class of property pursuant to section 4.02(1) or (2) of this revenue procedure. The taxpayer has the option of claiming this additional first year depreciation either by:

(1) filing an amended federal tax return (or a qualified amended return under Rev. Proc. 94–69 (1994–2 C.B. 804), if applicable) on or before the due date (*excluding* extensions) of the federal tax return for the next succeeding taxable year. The amended return (or qualified amended return) should include the statement "Filed Pursuant to Rev. Proc. 2002–33" at the top of the amended return (or qualified amended return); or

(2) Filing a Form 3115, *Application for Change in Accounting Method*, with the taxpayer's federal tax return for the next succeeding taxable year. This Form 3115 is to be filed in accordance with the automatic change in method of accounting provisions in Rev. Proc. 2002–9 (2002–3 I.R.B. 327), as modified by Rev. Proc. 2002–19 (2002–13 I.R.B. 696), and as modified and clarified by Announcement 2002–17 (2002–8 I.R.B. 561) (or any successor) with the following modifications:

(a) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply, and

(b) To assist the Service in processing changes in method of accounting under this section of the revenue procedure, and to ensure proper handling, section 6.02(4)(a) of Rev. Proc. 2002–9 is modified to require that a Form 3115 filed under this revenue procedure include the statement: "Automatic Change Filed Under Rev. Proc. 2002–33." This statement should be legibly printed or typed on the appropriate line on any Form 3115 filed under this revenue procedure.

.02 *Election Not to Deduct Additional First Year Depreciation.*

(1) *In general.* A taxpayer that has filed a 2000 or 2001 federal tax return before June 1, 2002, has made the election not to deduct the additional first year depreciation for a class of property that is qualified property or Liberty Zone property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year, if:

(a) the taxpayer made the election within the time prescribed in section 3.03(1) or 3.03(2)(a) of this revenue procedure and in the manner prescribed in the instructions for the 2001 Form 4562 (Rev. March 2002); or

(b) the taxpayer made the election within the time prescribed in section 3.03(1) or 3.03(2)(a) of this revenue procedure and included with the taxpayer's 2000 or 2001 federal tax return an affirmative statement to the effect that the taxpayer is not deducting the additional first year depreciation for the class of property. The affirmative statement may be a statement attached to, or written on, the return (for example, writing on the Form 4562 "not deducting 30 percent").

(2) *Deemed election.* If section 4.02(1) of this revenue procedure does not apply, a taxpayer that has filed a 2000 or 2001 federal tax return before June 1, 2002, will also be treated as making the election not to deduct the additional first year depreciation for a class of property that is qualified property or Liberty Zone property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year, if the taxpayer:

(a) on that return, did not claim the additional first year depreciation for that class of property but did claim depreciation; and

(b) does not file an amended federal tax return (or a qualified amended return) or a Form 3115 within the time prescribed in section 4.01 of this revenue procedure to claim the additional first year depreciation for the class of property.

.03 *Increased Section 179 Expensing for Liberty Zone Property.* If a taxpayer has filed a 2000 or 2001 federal tax return before June 1, 2002, and did not elect on that return to expense the increased § 179 amount for § 179 property that is Liberty Zone property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year, the taxpayer must file an amended return (or a qualified amended return under Rev. Proc. 94–69, if applicable) on or before the due date (*excluding* extensions) of the federal tax return for the next succeeding taxable year to make this election. This amended return (or qualified amended return) should include the statement "Filed Pursuant to Rev. Proc. 2002–33" at the top of the amended return (or qualified amended return).

.04 *Liberty Zone Leasehold Improvement Property.* If a taxpayer has filed a 2000 or 2001 federal tax return before June 1, 2002, and did not depreciate on that return Liberty Zone leasehold improvement property placed in service by the taxpayer after September 10, 2001, during the 2000 or 2001 taxable year as 5-year property for purposes of § 168 using the straight-line method of depreciation, the taxpayer should file an amended tax return (or a qualified amended return under Rev. Proc. 94–69, if applicable) before the taxpayer files the federal tax return for the next succeeding taxable year. The amended return (or qualified amended return) should include the statement "Filed Pursuant to Rev. Proc. 2002–33" at the top of the amended return (or qualified amended return).

SECTION 5. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 2002–9 is modified and amplified to include the accounting method change provided in section 4.01 of this revenue procedure in section 2 of the APPENDIX.

.02 Section 2.01 of the APPENDIX of Rev. Proc. 2002–9 is modified as follows:

(1) Section 2.01(2)(a)(ii) of the APPENDIX is modified to read as follows:

"(ii) for which depreciation is determined under § 56(a)(1), § 56(g)(4)(A), § 167, § 168, § 197, § 1400L(b), or § 1400L(c), or under § 168 prior to its amendment in 1986 (former § 168); and"

(2) Section 2.01(2)(c)(vi) of the APPENDIX is modified to read as follows:

"(vi) any property for which a taxpayer is revoking a timely valid election, or making a late election, under § 167, § 168, § 1400L(b), former § 168, or § 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (1993 Act), 1993–3 C.B. 1, 128 (relating to amortizable § 197 intangibles). A taxpayer may request consent to revoke or make the election by submitting a request for a letter ruling under Rev. Proc. 2002–1 (2002–1 I.R.B. 1) (or any successor);"

(3) Section 2.01(2)(c)(xii) of the APPENDIX is modified to read as follows:

"(xii) any change in method of accounting involving both a change from treating the cost or other basis of the property as nondepreciable property to treating the cost or other basis of the property as depreciable property and the adoption of a method of accounting for depreciation requiring an election under

§ 167, §168, § 1400L(b), former § 168, or § 13261(g)(2) or (3) of the 1993 Act (for example, a change in the treatment of the space consumed in landfills placed in service in 1990 from nondepreciable to depreciable property (assuming section 2.01(2)(c)(xiii) of the APPENDIX does not apply) and the making of an election under § 168(f)(1) to depreciate this property under the unit-of-production method of depreciation under § 167);"

(4) Section 2.01(6)(d) of the APPENDIX is modified to read as follows:

"(d) *Section 167 property*. Generally, for any taxable year, the depreciation allowable for property for which depreciation is determined under § 167, is determined either:

(i) under the depreciation method adopted by a taxpayer for the property; or

(ii) if that depreciation method does not result in a reasonable allowance for depreciation or a taxpayer has not adopted a depreciation method for the property, under the straight-line depreciation method.

For determining the estimated useful life and salvage value of the property, see § 1.167(a)–1(b) and (c), respectively.

The depreciation allowable for any taxable year for property subject to § 167(f) (regarding certain property excluded from § 197) is determined by using the depreciation method and useful life prescribed in § 167(f). If computer software is depreciated under § 167(f)(1) and is qualified property (as defined in § 168(k)(2)) or qualified New York Liberty Zone (Liberty Zone) property (as defined in § 1400L(b)(2)), the depreciation allowable for that computer software under § 167(f)(1) is also determined by taking into account the additional 30 percent depreciation (additional first year depreciation) deduction provided by § 168(k) or § 1400L(b), as applicable, unless the taxpayer made a timely valid election not to deduct the additional first year depreciation for the property."

(5) Section 2.01(6)(e) of the APPENDIX is modified to read as follows:

"(e) *Section 168 property*. The depreciation allowable for any taxable year for property for which depreciation is determined under § 168, is determined as follows:

(i) by using either:

(A) the general depreciation system in § 168(a); or

(B) the alternative depreciation system in § 168(g) if the property is required to be depreciated under the alternative depreciation system pursuant to § 168 (g)(1) or other provisions of the Code (for example, property described in § 263A (e)(2)(A) or § 280F(b)(1)). Property required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) includes property in a class (as set out in § 168(e)) for which the taxpayer made a timely election under § 168 (g)(7); and

(ii) if the property is qualified property or Liberty Zone property, by taking into account the additional first year depreciation deduction provided by § 168(k) or § 1400L(b), as applicable, unless the taxpayer made a timely valid election not to deduct the additional first year depreciation for the property."

(6) Section 2.01(6) of the APPENDIX is modified by adding a new paragraph (h) to read as follows:

"(h) *Qualified New York Liberty Zone leasehold improvement property*. The depreciation allowable for any taxable year for qualified New York Liberty Zone leasehold improvement property (as defined in § 1400L(c)(2)) is determined by using the depreciation method and recovery period prescribed in § 1400L(c)."

.03 Section 2.02(2)(c)(vi) of the APPENDIX of Rev. Proc. 2002–9 is modified as follows:

"(vi) any property for which depreciation is determined under § 56(a)(1), § 56(g)(4)(A)(i), (ii), (iii), or (v), § 168, § 1400L(b), or § 1400L(c), or under § 168 prior to its amendment in 1986 (former § 168);"

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for qualified property, Liberty Zone property, and Liberty Zone leasehold improvement property placed in service after September 10, 2001.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Douglas Kim and Kathleen Reed of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mr. Kim at (202) 622–3110 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Guidance Necessary to Facilitate Electronic Tax Administration

REG–107184–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: The IRS is proposing regulations designed to eliminate regulatory impediments to the electronic filing of the Form 1040, *U.S. Individual Income Tax Return*. The text of the temporary regulations (T.D. 8989) published in this issue of the Bulletin also serves as the text of these proposed regulations. These regulations generally affect taxpayers who file Form 1040 electronically and who are required to file any of the following forms: Form 56, *Notice Concerning Fiduciary Relationship*; Form 2120, *Multiple Support Declaration*; Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*; Form 3468, *Investment Credit*; and Form T (Timber), *Forest Activities Schedules*.

DATES: Written or electronically generated comments and requests for a public hearing must be received by July 23, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–107184–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–107184–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, James C. Gibbons, (202) 622–4910; concerning submissions of comments and/or requests for a hearing, LaNita Van Dyke, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

PAPERWORK REDUCTION ACT

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR: MP:FP:S, Washington, DC 20224. Comments on the collections of information should be received by June 24, 2002. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collections of information in this proposed regulation are in §§ 1.48–12T(d)(7), 1.152–3T(c), 1.611–3T(h), 1.852–9T(c), and 301.6903–1T(b). The proposed regulations require taxpayers to retain their tax records for as long as the contents may become material in the administration of any internal revenue law. This information is required for substantiation purposes. This information will be used to verify the information provided by the taxpayer. The likely respondents are individuals.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103. The burden imposed in §§ 1.48–12T(d)(7), 1.152–3T(c), 1.611–3T(h), 1.852–9T(c), and 301.6903–1T(b) will be reflected in Form 3468, Form 2120, Form T (Timber), Form 2439, and Form 56 respectively.

Background

Temporary regulations in this issue of the Bulletin contain amendments to the Income Tax Regulations (26 CFR part 1) and the Procedure and Administration Regulations (26 CFR part 301) designed to eliminate regulatory impediments to the electronic filing of the Form 1040. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations. Generally, the regulations will be effective for taxable years beginning after December 31, 2001. Taxpayers may, however, rely on these proposed regulations to the extent that the impediments were removed in forms filed for taxable years beginning after December 31, 2000.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section

553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the persons responsible for recordkeeping are principally individuals, and the burden is not significant as described earlier in the preamble. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7508(f) of the Internal Revenue Code, this notice will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies of written comments) that are submitted timely (in the manner described in the ADDRESSES caption) to the IRS. The IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested by any person who timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Sara Paige Shepherd, Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

Par. 1. The authority citation for part 1 continues to read as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.48–12, paragraph (d)(7)(iii) is revised to read as follows:

§ 1.48–12 Qualified rehabilitated building; expenditures incurred after December 31, 1981.

* * * * *

(d) * * *

(7)(iii) [The text of proposed paragraph (d)(7)(iii) is the same as the text of § 1.48–12T(d)(7)(iii) published elsewhere in this issue of the **Federal Register**].

Par. 3. In § 1.152–3, paragraph (c) is revised to read as follows:

§ 1.152–3 Multiple support agreements.

* * * * *

(c) [The text of proposed paragraph (c) is the same as the text of § 1.152–3T(c) published elsewhere in this issue of the **Federal Register**].

* * * * *

Par. 4. Section 1.611–3, paragraph (h) is revised to read as follows:

§ 1.611–3 Rules applicable to timber.

* * * * *

(h)[The text of proposed paragraph (h) is the same as the text of § 1.611–3T(h) published elsewhere in this issue of the **Federal Register**].

Par. 5. In § 1.852–9, paragraph (c)(1) is revised to read as follows:

§ 1.852–9 Special procedural requirements applicable to designation under section 852(b)(3)(D).

* * * * *

(c)(1) [The text of proposed paragraph (c)(1) is the same as the text of § 1.852–9T(c)(1) published elsewhere in this issue of the **Federal Register**].

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 6. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 7. Section 301.6011–1 is revised to read as follows:

§ 301.6011–1 General Requirement of return, statement or list.

[The text of proposed section is the same as the text of §301.6011–1T published elsewhere in this issue of the **Federal Register**].

Par. 8. Section 301.6903–1(b) is added to read as follows:

§ 301.6903–1 Notice of fiduciary.

* * * * *

(b)[The text of proposed paragraph (b) is the same as the text of §301.6903–1T(b) published elsewhere in this issue of the **Federal Register**].

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 23, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 24, 2002, 67 F.R. 20072)

Withdrawal of Notice of Proposed Rulemaking and Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition

REG–163892–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking; and notice of proposed

rulemaking by cross-reference to temporary regulations.

SUMMARY: This document withdraws the notice of proposed rulemaking (REG–107566–00, 2001–1 C.B. 346) published in the **Federal Register** on January 2, 2001. In this issue of the Bulletin, the IRS is issuing temporary regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. The text of those regulations also serves as the text of these proposed regulations.

DATES: Written and electronic comments and requests for a public hearing must be received by July 25, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–163892–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–163892–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Amber R. Cook at (202) 622–7530; concerning submissions, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On January 2, 2001, the IRS and Treasury published in the **Federal Register** (66 FR 66) a notice of proposed rulemaking (REG–107566–00) under section 355(e) of the Internal Revenue Code of 1986. Those proposed regulations are withdrawn.

Temporary regulations (T.D. 8988 on page 929 of this Bulletin) in the Rules and Regulations section of the **Federal Register** amend the Income Tax Regulations (26 CFR part 1) relating to section 355(e). The temporary regulations provide rules relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) and electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Amber R. Cook, Office of Associate Chief Counsel (Corporate). Other personnel from the IRS and Treasury Department, however, participated in their development.

* * * * *

Withdrawal of Proposed Amendments to the Regulations and Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805 and 26 U.S.C. 355(e)(5), the notice of proposed rulemaking (REG–107566–00) that was published in the **Federal Register** on Tuesday, January 2, 2001, (66 FR 66) is withdrawn. In addition, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.355–7 also issued under 26 U.S.C. 355(e)(5). * * *

Par. 2. Section 1.355–0 is amended by revising the introductory text and adding an entry for § 1.355–7 to read as follows:

§ 1.355–0 Table of contents.

In order to facilitate the use of §§ 1.355–1 through 1.355–7, this section lists the major paragraphs in those sections as follows:

* * * * *

§ 1.355–7 Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

(a) In general.
(b) Plan.
(1) In general.
(2) Certain post-distribution acquisitions.
(3) Plan factors.
(4) Non-plan factors.
(c) Operating rules.
(1) Internal discussions and discussions with outside advisors evidence of business purpose.
(2) Takeover defense.
(3) Effect of distribution on trading in stock.
(4) Consequences of section 355(e) disregarded for certain purposes.
(5) Multiple acquisitions.
(d) Safe harbors.
(1) Safe Harbor I.
(2) Safe Harbor II.
(3) Safe Harbor III.
(4) Safe Harbor IV.
(5) Safe Harbor V.

(i) In general.

(ii) Special rules.

(6) Safe Harbor VI.

(i) In general.

(ii) Special rule.

(7) Safe Harbor VII.

(i) In general.

(ii) Special rule.

(e) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests.

(1) Treatment of options.

(i) General rule.

(ii) Agreement, understanding, or arrangement to write an option.

(iii) Substantial negotiations related to options.

(2) Instruments treated as options.

(3) Instruments generally not treated as options.

(i) Escrow, pledge, or other security agreements.

(ii) Compensatory options.

(iii) Options exercisable only upon death, disability, mental incompetency, or separation from service.

(iv) Rights of first refusal.

(v) Other enumerated instruments.

(f) Multiple controlled corporations.

(g) Valuation.

(h) Definitions.

(1) Agreement, understanding, arrangement, or substantial negotiations.

(2) Controlled corporation.

(3) Controlling shareholder.

(4) Coordinating group.

(5) Discussions.

(6) Established market.

(7) Five-percent shareholder.

(8) Similar acquisition.

(9) Ten-percent shareholder.

(i) [Reserved]

(j) Examples.

(k) Effective date.

Par. 3. Section 1.355–7 is added to read as follows:

§ 1.355–7 Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

[The text of proposed § 1.355–7 is the same as the text of § 1.355–7T published elsewhere in this issue of the Bulletin].

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 23, 2002, 12:14 p.m., and published in the issue of the Federal Register for April 26, 2002, 67 F.R. 20711)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

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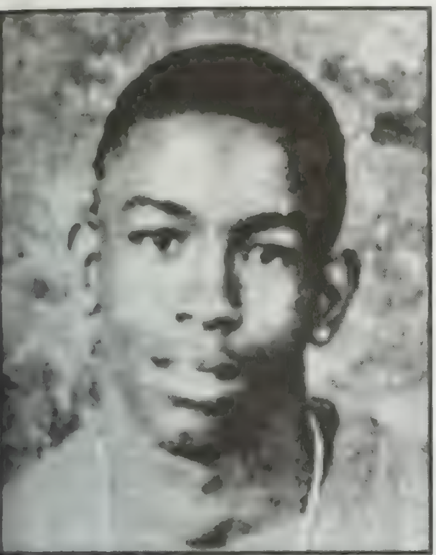

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bulletin

Bulletin No. 2002–21
May 28, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–30, page 971.
Notional principal contract. This ruling provides that where a nonperiodic payment made pursuant to a notional principal contract is comprised of noncontingent and contingent components, the parties must recognize the noncontingent component of the nonperiodic payment over the term of the notional principal contract.

T.D. 8992, page 981.
Final regulations under section 6050S relate to information reporting, including magnetic media reporting requirements for payments of interest on qualified education loans (Form 1098–E) and the continuation of Notice 98–7 for the calendar year 2002.

REG–161424–01, page 1010.
Proposed regulations under section 6050S relate to information reporting, including magnetic media reporting for qualified tuition and related expenses (Form 1098–T) and the continuation of Notice 97–73 for the calendar year 2002. A public hearing is scheduled for August 13, 2002. REG–105316–98 withdrawn.

Notice 2002–35, page 992.
Notional principal contract tax shelter. The Service may challenge transactions using notional principal contracts to claim current deductions for periodic payments made by a taxpayer while disregarding the accrual of a right to receive offsetting payments in the future. These transactions are designated as "listed transactions" for purposes of sections 1.6011–4T(b)(2) and 301.6111–2T of the regulations.

Rev. Proc. 2002–36, page 993.
Methods of accounting; taxable year of inclusion; basis. This procedure provides taxpayers that purchase vehicles subject to leases and assume the associated leases from motor vehicle dealers with a safe harbor method of accounting for capital cost reduction payments made by vehicle lessees, and a procedure for taxpayers to obtain automatic consent of the Commissioner to change to the safe harbor method of accounting. Rev. Proc. 2002–9 modified and amplified.

EMPLOYEE PLANS

REG–136193–01, page 995.
Proposed regulations under section 4980F of the Code provide guidance on the requirements for plan administrators to give notice of plan amendments that provide for significant reduction in the rate of future benefit accrual or an early retirement benefit or retirement-type subsidy. When finalized, the regulations will affect businesses, nonprofit organizations, and individuals. A public hearing is scheduled for August 15, 2002.

Notice 2002–32, page 989.
Weighted average interest rate update. The weighted average interest rate for May 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

T.D. 8991, page 972.
Final regulations under section 513 of the Code provide guidance concerning whether corporate sponsorship payments to tax-exempt organizations are unrelated business taxable income.

Notice 2002–34, page 990.
This notice announces and provides guidance for a voluntary compliance program to promote disclosure for political organizations that file Forms 8871, 8872, 1120–POL, 990, and 990–EZ by July 15, 2002.

ADMINISTRATIVE

Notice 2002–33, page 989.
Section 809 information return. This notice suspends the requirement that mutual life insurance companies and the 50 largest stock life insurance companies file Form 8390, *Information Return for Determination of Life Insurance Company Earnings Rate Under Section 809*, in 2002 and 2003 due to section 809(j) which was added to the Code by the Job Creation and Workers Assistance Act of 2002.

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Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 61.—Gross Income Defined

26 CFR 1.61–1: Gross income.

Under the CCR method of accounting, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle. See Rev. Proc. 2002–36, page 993.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

Under the CCR method of accounting, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle. See Rev. Proc. 2002–36, page 993.

26 CFR 1.446–3: Notional Principal Contracts.

Notional Principal Contract. This ruling provides that where a nonperiodic payment made pursuant to a notional principal contract is comprised of noncontingent and contingent components, the parties must recognize the noncontingent component of the nonperiodic payment over the term of the notional principal contract.

Rev. Rul. 2002–30

ISSUE

What is the appropriate method for the inclusion into income or deduction of a nonperiodic payment made pursuant to a notional principal contract where the payment is comprised of noncontingent and contingent components?

FACTS

T enters into a notional principal contract ("NPC") with *CP* on October 1, 2002, for a term of 18 months. Pursuant to the terms of the NPC, *T* agrees to make quarterly payments to *CP* based on three-month LIBOR multiplied by a notional principal amount of $100,000,000. In exchange, *CP* agrees that upon expiration of the NPC on March 31, 2004, *CP* will pay *T* 6 percent per year multiplied by a notional principal amount of $92,000,000 (the fixed payment amount). In addition, *CP* or *T* will make a payment upon expiration equal to the percentage change in the value of the S&P 500 stock index multiplied by a notional principal amount of $8,000,000. If the change is positive (an appreciation amount), *CP* will make a payment to *T*; if the change is negative (a depreciation amount), *T* will make a payment to *CP*. Any depreciation amount payable by *T* will be netted against the fixed payment amount payable by *CP*.

LAW

Section 1.446–3 of the Income Tax Regulations provides rules on the timing of inclusion of income and deductions for amounts paid or received pursuant to NPCs.

Section 1.446–3(c)(1)(i) defines a NPC as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount, in exchange for specified consideration or a promise to pay similar amounts. Payments made pursuant to NPCs are divided into three categories (periodic, nonperiodic, and termination payments), and the regulations provide separate timing regimes for each.

Section 1.446–3(e)(1) defines periodic payments as payments made or received pursuant to a NPC that are payable at intervals of one year or less during the entire term of the contract, that are based on a specified index, and that are based on a notional principal amount. Section 1.446–3(e)(2) provides that all taxpayers, regardless of their methods of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.

Section 1.446–3(h)(1) defines a termination payment as a payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a NPC.

Section 1.446–3(f)(1) provides that a nonperiodic payment is any payment made or received with respect to a NPC that is not a periodic payment or a termination payment. The recognition rules for nonperiodic payments are set forth in § 1.446–3(f)(2). Section 1.446–3(f)(2)(i) provides that all taxpayers, regardless of their methods of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a NPC in a manner that reflects the economic substance of the contract.

Section 1.446–3(f)(2)(ii) provides generally that a nonperiodic payment must be recognized over the term of the contract by allocating it in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.

Section 1.446–3(f)(2)(iii)(A) provides that an upfront payment may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level payment method).

Section 1.446–3(f)(2)(iii)(B) provides that nonperiodic payments other than an upfront payment may be amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties. The single upfront payment is then amortized under the level payment method described in § 1.446–3(f)(2)(iii)(A). The time value component of the loan is not treated as interest, but together with the amortized amount of the deemed upfront payment, is recognized as a periodic payment. *See* § 1.446–3(f)(4), Example 6, for an illustration of these rules.

Section 1.446–3(g)(4) provides that a swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is not included in the net income or net deduction from the swap under § 1.446–3(d) of this section, but is recognized as

interest for all purposes of the Internal Revenue Code.

Section 1.446–3(d) provides that for all purposes of the Code, the net income or net deduction from a NPC for a taxable year is included in, or deducted from, gross income for that taxable year. The net income or net deduction from a NPC for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year under § 1.446–3(e), and all of the nonperiodic payments that are recognized from that contract for the taxable year under § 1.446–3(f). Each party to the NPC determines its payments and receipts attributable to the taxable year and takes into account, as net income or net deduction, the result of those payments and receipts. *See* § 1.446–3(e)(3), Example 1; and § 1.446–3(g)(6), Example 3.

ANALYSIS

The agreement between *T* and *CP* is a NPC as defined in § 1.446–3(c)(1)(i). Pursuant to the terms of the contract, *T* will pay to *CP* amounts based on LIBOR quarterly, in exchange for *CP*'s promise to pay specified consideration at expiration.

The amounts that *T* pays to *CP* are periodic payments as defined in § 1.446–3(e)(1). These LIBOR-based payments are payable at intervals of less than one year and are calculated by reference to a specified index upon a notional principal amount of $100,000,000. Pursuant to § 1.446–3(e)(2), *T* and *CP* must recognize the ratable daily portion of each periodic payment for the taxable year to which that portion relates.

The amount payable on March 31, 2004, is a nonperiodic payment, which *T* and *CP* are required to recognize over the term of the NPC in a manner that reflects the economic substance of the NPC. In substance, the nonperiodic payment that *CP* must pay *T* on expiration equals the sum of two independent components, one noncontingent and the other contingent. The noncontingent component (the fixed payment amount) equals $8,280,000, that is the product of 6 percent per year, or 9 percent for 18 months, and the notional principal amount of $92,000,000. The contingent component (the appreciation or depreciation amount) equals the product of the percentage appreciation or depreciation in the value of the S&P 500 stock index and the notional principal amount of $8,000,000. In order to reflect the economic substance of the NPC, each component must be treated separately for purposes of applying the NPC rules in § 1.446–3. As a result, pursuant to § 1.446–3(f)(2)(i), the fixed payment amount due on March 31, 2004, must be recognized over the term of the NPC in a manner consistent with § 1.446–3(f)(2)(ii) or (iii). This treatment of the fixed payment amount payable by *CP* is not affected by the possibility that *T* may be required to pay a depreciation amount to *CP* that, under the terms of the NPC, will be netted against *CP*'s obligation to pay the fixed payment amount. Pursuant to § 1.446–3(g)(4), *T* must accrue interest income and *CP* may accrue interest deductions.

HOLDING

T and *CP* must recognize the noncontingent component of the nonperiodic payment over the term of the NPC, and must also account for interest, in a manner consistent with §§ 1.446–3(f)(2)(ii) or (iii), and 1.446–3(g)(4).

DRAFTING INFORMATION

The principal author of this revenue ruling is Elizabeth Handler of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Handler at (202) 622–3930 (not a toll-free call).

Section 451.—General Rule for Taxable Year of Inclusion

26 CFR 1.451–1: General rule for taxable year of inclusion.

Under the CCR method of accounting, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle. See Rev. Proc. 2002–36, page 993.

Section 481.—Adjustments Required for Changes in Method of Accounting

26 CFR 1.481–1: Adjustments in general.
26 CFR 1.481–4: Adjustments taken into account with consent.

A purchaser of a motor vehicle that is subject to a lease in connection with which a lessee has made a CCR payment to the dealer from which the lessee originally leased the vehicle may obtain automatic consent to change to the CCR method of accounting. See Rev. Proc. 2002–36, page 993.

Section 513.—Unrelated Trade or Business

26 CFR 1.513–4: Certain sponsorship not unrelated trade or business.

T.D. 8991

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Taxation of Tax-Exempt Organizations' Income From Corporate Sponsorship

AGENCY: Internal Revenue Service (IRS), Treasury Department.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of corporate sponsorship payments received by tax-exempt organizations. The final regulations affect exempt organizations that receive sponsorship payments.

DATES: *Effective Date*: These regulations are effective April 25, 2002.

Applicability Date: These regulations are applicable for payments solicited or received after December 31, 1997.

FOR FURTHER INFORMATION CONTACT: Stephanie Lucas Caden or Barbara E. Beckman of Office of Associate Chief Counsel (TE/GE), (202) 622–6080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Exempt organizations generally must pay tax on unrelated business taxable income, as defined in section 512. Section 512(a)(1) defines *unrelated business taxable income* (UBTI) as the gross income derived by an organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions that are directly connected with the carrying on of the trade or business, both computed with the modifications provided in section 512(b).

Section 513(a) defines *unrelated trade or business* as any trade or business the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. Section 513(c), captioned "Advertising, etc., activities," provides that the term *trade or business* includes any activity carried on for the production of income from the sale of goods or the performance of services, and that an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. See § 1.513–1(b).

The IRS first published a notice of proposed rulemaking (EE–74–92, 1993–1 C.B. 708) (1993 proposed regulations) on January 22, 1993 (58 F.R. 5687), proposing that the regulations under section 513 be amended to provide guidance on the proper tax treatment of sponsorship payments received by an exempt organization. The 1993 proposed regulations focused on the nature of the services provided by the exempt organization rather than the benefit received by the sponsor, and distinguished advertising, which is an unrelated trade or business activity, from acknowledgments, which are the mere recognition of a sponsor's payment and therefore do not result in UBTI. In a so-called "tainting rule," the 1993 proposed regulations provided that if any activities, messages or programming material constituted advertising with respect to a sponsorship payment, then all related activities, messages, or programming material that might otherwise be acknowledgments would be considered advertising. The 1993 proposed regulations also proposed to amend the regulations under section 512(a) by adding examples of the allocation rule governing exploitation of exempt activities in cases involving sponsorship income.

The Taxpayer Relief Act of 1997, Public Law 105–34, section 965 (111 Stat. 788, 893–94), amended the Internal Revenue Code (Code) by adding section 513(i). Section 513(i) governs the treatment of certain sponsorship payments by providing that qualified sponsorship payments are not subject to the unrelated business income tax (UBIT). Section 513(i) defines *qualified sponsorship payments* as payments made by a person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the exempt organization's activities. Section 513(i) further provides that use or acknowledgment does not include advertising (including messages containing qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use a sponsor's products or services).

Section 513(i) specifically provides that, to the extent a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, that portion of such payment and the other portion of such payment are treated as separate payments. Whether a separate transaction that falls outside of the section 513(i) safe harbor is subject to the UBIT depends on the application of existing rules under sections 512, 513, and 514.

Section 513(i) applies to payments solicited or received after December 31, 1997. Section 513(i) does not apply to qualified convention and trade show activities (described in section 513(d)(3)(B)) or to the sale of an acknowledgment or advertising in exempt organization periodicals. For this purpose, the term *periodicals* means regularly scheduled and printed material published by or on behalf of an exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization.

To reflect the differences between the 1993 proposed regulations and section 513(i), and in response to comments submitted on the 1993 proposed regulations, new proposed regulations (REG–209601–92, 2000–1 C.B. 829) (2000 proposed regulations) were issued on March 1, 2000 (65 F.R. 11012).

The 2000 proposed regulations amend the regulations under section 513, and provide that qualified sponsorship payments within the meaning of section 513(i) are not UBTI. The 2000 proposed regulations define the phrase "substantial return benefit" to mean any benefit other than (1) a use or acknowledgment of the payor's name or logo in connection with the exempt organization's activities, or (2) certain goods or services that have an insubstantial value under existing IRS guidelines. Generally, according to the 2000 proposed regulations, benefits such as complimentary tickets, pro-am playing spots, and receptions for donors have an insubstantial value only if they have a fair market value of not more than 2% of the payment, or $74 (adjusted for inflation for tax years beginning after calendar year 2000 pursuant to section 1(f)(3)), whichever is less. See § 1.170A–13(f)(8)(i)(A); Rev. Proc. 90–12 (1990–1 C.B. 471), as adjusted for inflation (for calendar year 2002, the amount is $79, see Rev. Proc. 2001–59 (2001–52 I.R.B. 623) (December 26, 2001)).

The 2000 proposed regulations clarify that for an exempt organization to avail itself of the section 513(i) safe harbor, it must establish that some portion of the payment exceeds the fair market value of any substantial return benefit received by a payor in return for making the payment. In a sponsorship arrangement, the fair market value of the substantial return benefit may equal the entire amount of the sponsorship payment. The burden of establishing the fair market value of any substantial return benefit falls on the exempt organization. The 2000 proposed regulations state that the exempt organization's determination of the fair market value of a substantial return benefit provided to the payor will not be set aside

for purposes of applying the section 513(i) safe harbor so long as the organization makes a reasonable and good faith valuation of the substantial return benefit received by the payor.

The 2000 proposed regulations provide that the right to be the only sponsor of an activity, or the only sponsor representing a particular trade, business, or industry is generally not a substantial return benefit. Any portion of the payment attributable to the exclusive sponsorship arrangement, therefore, may be a qualified sponsorship payment. However, if in return for a payment, the exempt organization agrees that products or services that compete with the payor's products or services will not be sold or provided in connection with one or more activities of the exempt organization, the payor has received a substantial return benefit and the portion of the payment attributable to the exclusive provider arrangement is not a qualified sponsorship payment. Consistent with the allocation rule described above, when a payor receives both exclusive sponsorship and exclusive provider rights in exchange for making a payment, the fair market value of the exclusive provider arrangement and any other substantial return benefit is determined first (*i.e.*, without regard to the existence of the exclusive sponsorship arrangement).

The 2000 proposed regulations clarify that qualified sponsorship payments in the form of money or property (but not services) are treated as contributions received by the exempt organization for purposes of determining public support to the organization under section 170(b)(1)(A)(vi) or section 509(a)(2). The exclusion of contributed services for purposes of determining public support is consistent with the general rule regarding donated services. See §§ 1.509(a)–3(f), 1.170A–9(e)(7)(i) and 1.170A–1(g).

A public hearing was held on June 21, 2000. After consideration of all the comments, the proposed regulations under section 513(i) are revised as follows. The major areas of the comments and revisions are discussed below.

Explanation of Provisions and Discussion of Comments

Like the 2000 proposed regulations, the final regulations define the phrase *substantial return benefit* to mean any benefit other than (1) a use or acknowledgment of the payor's name or logo in connection with the exempt organization's activities, or (2) certain goods or services that have an insubstantial value. If a payor receives a substantial return benefit in exchange for a payment, the section 513(i) safe harbor does not apply to the payment (or portion thereof) attributable to the substantial return benefit. In that case, whether the payment (or portion thereof) is subject to UBIT must be determined under existing principles and rules. Thus, the payment may not be subject to UBIT because the exempt organization's activity is not an unrelated trade or business within the meaning of section 513(a) (for example, because substantially all of the work in carrying on the trade or business is performed by volunteers) or is not regularly carried on within the meaning of section 512(a)(1), or because one of the section 512(b) modifications applies. See also Rev. Rul. 77–367 (1977–2 C.B. 193) (inurement) and Rev. Rul. 66–358 (1966–2 C.B. 218) (private benefit).

Many comments were received regarding the disregarded benefits standard contained in the 2000 proposed regulations. Commentators generally believe that valuing insubstantial benefits places an undue administrative burden on exempt organizations. Commentators also believe that the disregarded benefits standard in the proposed regulation is too low and significantly diminishes an exempt organization's ability to appropriately thank its sponsors. While the $79 ceiling (as adjusted for 2002) is an appropriate amount for exempt organizations to thank individual donors, the Treasury Department and IRS agree with the commentators that the $79 ceiling is too low with respect to corporations or persons engaged in a trade or business. In response to these concerns, the final regulations eliminate the $79 ceiling placed on the fair market value of benefits that may be disregarded for purposes of section 513(i).

Several commentators suggest that in addition to eliminating the $79 ceiling, the final regulations should increase the level of disregarded benefits to 10% or 15% of the amount of the payment. The Treasury Department and IRS believe 2% is an appropriate level for several reasons. The 2% threshold is used in other areas of the Code and regulations to describe insubstantial amounts. The 2000 proposed regulations allow the full amount of qualified sponsorship payments (except for payments in the form of services) to be treated as contributions for purposes of the public support test under sections 170(b)(1)(A)(vi) and 509(a)(2), without reduction for the amount of disregarded benefits. The 2% ceiling keeps the level of disregarded benefits low enough so that the entire amount of a qualified sponsorship payment may be treated as a contribution for public support purposes. Accordingly, the final regulations disregard benefits having a fair market value of not more than 2% of the payment.

Many commentators to the 2000 proposed regulations object to a requirement that exempt organizations must value benefits provided to payors where the payment does not affect the organization's tax liability, *e.g.*, where the payment attributable to the benefit constitutes income from a trade or business that is substantially related to the organization's exempt purposes. The Treasury Department and IRS note that organizations described in section 170(c) (other than section 170(c)(1)) are required to account for benefits provided to donors under section 6115. See Publication 1771, "*Charitable Contributions—Substantiation and Disclosure Requirements.*" Pursuant to section 6115, a section 170(c) organization that receives a quid pro quo contribution in excess of $75 is required to inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the amount by which the payment exceeds the value of goods or services (except as provided in § 1.170A–13(f)(8)(i)) furnished by the charity, and is required to provide a good faith estimate of the value of those goods or services. Therefore, for exempt organizations eligible to receive tax deductible contributions, there is no additional tax administrative burden imposed by the disregarded benefits provision of either the 2000 proposed regulations or the final regulations.

The final regulations provide that in determining whether the 2% threshold has been exceeded in any year, all return

benefits (other than use or acknowledgment) must be considered. For example, if in exchange for a payment the exempt organization provides both a license and advertising the combined fair market value of which does not exceed 2% of the total payment, the entire payment (even the portion attributable to the advertising) may be treated as a qualified sponsorship payment, and the entire amount (except any payment in the form of services) constitutes public support under section 509. Alternatively, if the combined fair market value exceeds 2% of the total payment, the value of both the license and advertising is not disregarded and constitutes a substantial return benefit. In that case, the portions of the payment attributable to the license and advertising each must be analyzed separately under sections 512, 513, and 514. Only the portion of the payment, if any, that exceeds the fair market value of the substantial return benefit constitutes a qualified sponsorship payment.

Consistent with the 2000 proposed regulations, the final regulations provide that the right to be the only sponsor of an activity, or the only sponsor representing a particular trade, business or industry is generally not a substantial return benefit. The portion of any payment attributable to the exclusive sponsorship arrangement, therefore, may be a qualified sponsorship payment. However, if in return for a payment, the exempt organization agrees that products or services that compete with the payor's products or services will not be sold or provided in connection with one or more activities of the exempt organization, the payor has received a substantial return benefit and the portion of the payment attributable to the exclusive provider arrangement is not a qualified sponsorship payment.

Some commentators express concern that the definition of exclusive provider arrangements contained in the 2000 proposed regulations may include vendor contracts negotiated as part of a competitive bidding process required by state law. Both the 2000 proposed regulations and the final regulations provide that unless the exempt organization agrees to limit distribution of competing products in connection with the payment, the exempt organization has not entered into an exclusive provider arrangement. For example, when the nature of the goods or services to be provided necessitates the use of only one provider because of limited space or because the competitive bidding process requires only the lowest bid be accepted, the exempt organization has not entered into an exclusive provider arrangement unless it agrees to limit distribution of competing products.

In particular, these commentators express concern about the tax-treatment of discounts and rebates negotiated with vendors as part of the competitive bidding process. Generally, discounts (and rebates) are considered an adjustment to the purchase price and do not constitute gross income to the purchaser. See Rev. Rul. 84–41 (1984–1 C.B. 130); Rev. Rul. 76–96 (1976–1 C.B. 23). For example, when a university negotiates discounted rates for the soft drinks it purchases for its cafeterias, snack bars, and concessions, the amount of the discount is not includible in UBTI.

Many commentators suggest that the exclusive provider provisions in the 2000 proposed regulations create an implication that exclusive provider arrangements are automatically subject to UBIT because they fall outside the scope of section 513(i). This assumption is incorrect; although the income from some exclusive provider arrangements may be includible in UBTI, not all contracts will meet the criteria for inclusion in UBTI pursuant to sections 511, 512, and 513. For example, a university that enters into a multi-year contract with a soft drink company to be the exclusive provider of soft drinks on campus in return for an annual payment is not necessarily subject to UBIT on that payment. If the company agrees to provide, stock, and maintain on-campus vending machines as needed, leaving little or no obligation on the university's part to perform any services or conduct activities in connection with the enterprise, then based on this contract alone the university may not have the requisite level of activity to constitute a trade or business under section 513(a). This example assumes no agency relationship exists between the company and the university. In determining the level of activity, however, any promotional or marketing efforts by the university pursuant to the contract should be considered. If the contract grants the company a license to market its products using the university's name and logo, the portion of the total payment attributable to the value of the license may be excludable as a royalty under section 512(b)(2). In some cases, payments in connection with the grant of an exclusive concession, such as for the operation of a campus bookstore or cafeteria, may be treated as rental income under section 512(b)(3).

When an exempt organization agrees to perform substantial services in connection with the exclusive provider arrangement, income received by the organization may be includible in UBTI. For example, assume that a university enters into a multi-year contract with a sports drink company under which the company will be the exclusive provider of sports drinks for the university's athletic department and concessions. As part of the contract, if the university agrees to perform various services for the company, such as guaranteeing that coaches make promotional appearances on behalf of the company (*e.g.*, attending photo shoots, filmed commercials, and retail store appearances), assisting the company in developing marketing plans, and participating in joint promotional opportunities, then the university's activities are likely to constitute a regularly carried on trade or business. These activities are unlikely to be substantially related to the university's exempt purposes. Furthermore, the income received by the university for those services is not excludable as a royalty under section 512(b)(2). See Rev. Rul. 81–178 (1981–2 C.B. 135), situation 2.

The 2000 proposed regulations solicited comments on the application of the rules governing periodicals and trade shows to an exempt organization's Internet sites, and whether providing a link to a sponsor's Internet site is advertising within the meaning of section 513(i). The comments received generally suggest that a link to a corporate sponsor's Internet site as part of a sponsorship arrangement is not a message, but a convenient feature of the Internet that can only be activated by the viewer, and thus constitutes a permissible form of acknowledgment. With regard to periodicals, most commentators expressed the view that the term "periodical", for purposes of the section 513(i) exclusion, includes material published

electronically. Some commentators suggest that an exempt organization's Internet site should not be treated as a periodical simply because it has text that changes from time to time. Other commentators suggest criteria for analyzing whether an Internet site is a periodical.

Only a few comments were received on the application of the trade show exclusion in section 513(i) to an exempt organization's Internet site. These comments generally suggest that trade shows conducted over the Internet be treated the same as trade shows conducted in person. That is, payments made in connection with Internet-based trade shows would not be exempt from UBIT as qualified sponsorship payments, but would be exempt from UBIT as income generated by qualified convention and trade show activity.

Many options for addressing the Internet in the final regulations were considered. The final regulations take the approach that, where possible, answers are provided. However, the Treasury Department and IRS note that the analysis of particular Internet issues, such as the use of hyperlinks, may be different for purposes of section 513(i) than other sections of the Code. The Treasury Department and IRS also conclude that some Internet issues addressed in comments are beyond the scope of section 513(i).

For purposes of section 513(i), the issue of whether a hyperlink constitutes an acknowledgment or advertising is addressed in the final regulations with two new examples. In the first new example, the exempt organization posts a list of its sponsors on its website, including the sponsor's Internet address, which appears as a hyperlink from the exempt organization's website to the sponsor's website. The example concludes that posting the sponsor's website address constitutes an acknowledgment, even though it appears as a hyperlink. In the second new example, a charity maintains a website that contains a hyperlink to a sponsor's website where an endorsement by the charity for the sponsor's product appears. The charity approved the endorsement before it was posted on the sponsor's website. The example concludes that the endorsement is advertising. These two examples address hyperlinks for purposes of section 513(i) only, and do not suggest how hyperlinks are treated under other sections of the Code.

With respect to periodicals, section 513(i) mentions periodicals only in the sense that the safe harbor does not apply to any payment which entitles the payor to the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in exempt organization periodicals. Such payments are analyzed instead under the existing UBIT rules. Section § 1.512(a)–1(f) provides special rules for determining the amount of UBTI attributable to the sale of advertising in exempt organization periodicals. After considering the comments, the Treasury Department and IRS conclude that the regulations under section 512 are the more appropriate place for an analysis of issues relating to electronic periodicals. Nevertheless, the Treasury Department and IRS clarify that periodicals may include some forms of electronic publication. The final regulations state that the term *periodical* means regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization, and for this purpose, printed material includes material that is published electronically.

As noted above, relatively few comments were received on the trade show exclusion. Because of the small sampling of comments received, and because trade show rules impact many different industries and typically involve large sums of money, the final regulations do not change the rules on what constitutes a qualified convention and trade show activity. Existing guidance on trade shows is found in section 513(d) and § 1.513–3, and any reference to trade shows in the final regulations under section 513(i) is intended to be consistent with these rules.

Many commentators wrote regarding the valuation of substantial return benefits, and suggest that the 2000 proposed regulations do not offer enough guidance on how to make a reasonable and good faith valuation of a substantial return benefit. Commentators also assert that the valuation provisions do not further administrative convenience and simplicity. The fair market value of any substantial return benefit provided as part of a sponsorship arrangement is the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement and both having reasonable knowledge of relevant facts, and without regard to any other aspect of the sponsorship arrangement. While the Treasury Department and IRS appreciate the difficulty an exempt organization has in valuing substantial return benefits, the final regulations retain the valuation standard contained in the 2000 proposed regulations. Several commentators suggest incorporating safe harbors into the final regulations to determine the value of a substantial return benefit. For example, one commentator suggests that a safe harbor be added to provide that an exempt organization's valuation would not be challenged if it were determined based on the face amount of the tickets, cost of the dinner, or any reasonably comparable measure. Another commentator suggests that the fair market value be based on data provided by the payor, or as agreed by the parties. Another commentator favors predicting values of yearly benefits based on actual benefits provided over a three-year period. After considering these comments, the Treasury Department and IRS conclude that the safe harbors suggested by the commentators either are inconsistent with the general rule, do not provide any additional guidance, or are prone to abuse. For this reason, no safe harbors were added to the final regulations with respect to valuation.

Clarification is provided, however, with respect to the valuation date. The 2000 proposed regulations provide that in allocating a sponsorship payment, the fair market value of the substantial return benefit is to be determined on the date the parties enter into the sponsorship arrangement. The final regulations take the same approach for binding, written sponsorship contracts. This rule, which is illustrated by two new examples, provides exempt organizations the advantage of only having to value substantial return benefits once, even if the value of the substantial return benefit increases over the term of the contract. If the parties make a material change to a sponsorship contract, it is treated as a new contract as of the date the material change is effective. A material change is defined as an extension or

renewal of the contract, or a more than incidental change to any amount payable (or other consideration) under the contract. If there is no binding, written contract, the fair market value of the substantial return benefit is determined when the benefit is provided. The reason for distinguishing between written and oral agreements in the final regulations is to allow smaller exempt organizations to arrange sponsorship informally on a year-to-year basis and value those benefits each year as they occur.

Few comments were received on the § 1.512(a)–1(e) example relating to expense allocation. Of the comments received, most state that the 1993 proposed regulations did not interpret the exploitation exception too broadly, and request that the prior examples be reinstated. The commentators also suggest that the new example is factually unrealistic. Despite these comments, the final regulations do not change the § 1.512(a)–1(e) example. The comments received generally do not contain substantive suggestions for change, and the Treasury Department and IRS believe that the current example in the final regulations correctly amplifies the technical provisions of the regulation, which is very limited in scope.

Special Analyses

It has been determined that this decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the final rule does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these regulations were previously submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Stephanie Lucas Caden, Office of Division Counsel/Associate Chief Counsel (Tax Exempt/Government Entities), Internal Revenue Service. However, personnel from other offices of the Service and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.170A–9, a sentence is added to the end of paragraph (e)(6)(i) to read as follows:

§ 1.170A–9 Definition of section 170(b)(1)(A) organization.

* * * * *

(e) * * *

(6) * * * (i) * * * For purposes of this paragraph (e), the term *contributions* includes qualified sponsorship payments (as defined in § 1.513–4) in the form of money or property (but not services).

* * * * *

Par. 3. Section 1.509(a)–3 is amended by:

1. Adding a sentence to the end of paragraph (f)(1).
2. Revising the paragraph heading and introductory text for paragraph (f)(3).
3. Redesignating the current *Example* in paragraph (f)(3) as *Example 1* and revising the heading.
4. Adding *Example 2* and *Example 3* to paragraph (f)(3).

The revisions and additions read as follows;

§ 1.509(a)–3 Broadly, publicly supported organizations.

* * * * *

(f) * * * (1) * * * For purposes of section 509(a)(2), the term *contributions* includes qualified sponsorship payments (as defined in § 1.513–4) in the form of money or property (but not services).

* * * * *

(3) *Examples.* The provisions of this paragraph (f) may be illustrated by the following examples:

Example 1. * * *

Example 2. Q, a performing arts center, enters into a contract with a large company to be the exclusive sponsor of the center's theatrical events. The company makes a payment of cash and products in the amount of $100,000 to Q, and in return, Q agrees to make a broadcast announcement thanking the company before each show and to provide $2,000 of advertising in the show's program (2% of $100,000 is $2,000). The announcement constitutes use or acknowledgment pursuant to section 513(i)(2). Because the value of the advertising does not exceed 2% of the total payment, the entire $100,000 is a qualified sponsorship payment under section 513(i), and $100,000 is treated as a contribution for purposes of section 509(a)(2)(A)(i).

Example 3. R, a charity, enters into a contract with a law firm to be the exclusive sponsor of the charity's outreach program. Instead of making a cash payment, the law firm agrees to perform $100,000 of legal services for the charity. In return, R agrees to acknowledge the law firm in all its informational materials. The total fair market value of the legal services, or $100,000, is a qualified sponsorship payment under section 513(i), but no amount is treated as a contribution under section 509(a)(2)(A)(i) because the contribution is of services.

* * * * * *

Par. 4. Section 1.512(a)–1 is amended by:

1. Revising the paragraph heading and introductory text for paragraph (e).
2. Redesignating the current *Example* in paragraph (e) as *Example 1* and revising the heading.
3. Adding *Example 2* to paragraph (e).

The revisions and additions read as follows:

§ 1.512(a)–1 Definition.

* * * * *

(e) *Examples.* This section is illustrated by the following examples:

Example 1. * * *

Example 2. (i) P, a manufacturer of photographic equipment, underwrites a photography exhibition organized by M, an art museum described in section 501(c)(3). In return for a payment of $100,000, M agrees that the exhibition catalog sold by M in connection with the exhibit will advertise P's product. The exhibition catalog will also include educational material, such as copies of photographs included in the exhibition, interviews with photographers, and

an essay by the curator of M's department of photography. For purposes of this example, assume that none of the $100,000 is a qualified sponsorship payment within the meaning of section 513(i) and § 1.513–4, that M's advertising activity is regularly carried on, and that the entire amount of the payment is unrelated business taxable income to M. Expenses directly connected with generating the unrelated business taxable income (*i.e.*, direct advertising costs) total $25,000. Expenses directly connected with the preparation and publication of the exhibition catalog (other than direct advertising costs) total $110,000. M receives $60,000 of gross revenue from sales of the exhibition catalog. Expenses directly connected with the conduct of the exhibition total $500,000.

(ii) The computation of unrelated business taxable income is as follows:

(A) Unrelated trade or business (sale of advertising):			
	Income	$100,000	
	Directly-connected expenses	(25,000)	
	Subtotal	75,000	$75,000
(B) Exempt function (publication of exhibition catalog):			
	Income (from catalog sales)	60,000	
	Directly-connected expenses	(110,000)	
	Net exempt function income (loss)	(50,000)	(50,000)
	Unrelated business taxable income		25,000

(iii) Expenses related to publication of the exhibition catalog exceed revenues by $50,000. Because the unrelated business activity (the sale of advertising) exploits an exempt activity (the publication of the exhibition catalog), and because the publication of editorial material is an activity normally conducted by taxable entities that sell advertising, the net loss from the exempt publication activity is allowed as a deduction from unrelated business income under paragraph (d)(2) of this section. In contrast, the presentation of an exhibition is not an activity normally conducted by taxable entities engaged in advertising and publication activity for purposes of paragraph (d)(2) of this section. Consequently, the $500,000 cost of presenting the exhibition is not directly connected with the conduct of the unrelated advertising activity and does not have a proximate and primary relationship to that activity. Accordingly, M has unrelated business taxable income of $25,000.

* * * * *

Par. 5. Section 1.513–4 is added to read as follows:

§ 1.513–4 Certain sponsorship not unrelated trade or business.

(a) *In general.* Under section 513(i), the receipt of qualified sponsorship payments by an exempt organization which is subject to the tax imposed by section 511 does not constitute receipt of income from an unrelated trade or business.

(b) *Exception.* The provisions of this section do not apply with respect to payments made in connection with qualified convention and trade show activities. For rules governing qualified convention and trade show activity, see § 1.513–3. The provisions of this section also do not apply to income derived from the sale of advertising or acknowledgments in exempt organization periodicals. For this purpose, the term *periodical* means regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization. For this purpose, printed material includes material that is published electronically. For rules governing the sale of advertising in exempt organization periodicals, see § 1.512(a)–1(f).

(c) *Qualified sponsorship payment*—(1) *Definition.* The term *qualified sponsorship payment* means any payment by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit. In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the recipient organization's exempt purpose. It is also irrelevant whether the sponsored activity is temporary or permanent. For purposes of this section, payment means the payment of money, transfer of property, or performance of services.

(2) *Substantial return benefit*—(i) *In general.* For purposes of this section, a *substantial return benefit* means any benefit other than a use or acknowledgment described in paragraph (c)(2)(iv) of this section, or disregarded benefits described in paragraph (c)(2)(ii) of this section.

(ii) *Certain benefits disregarded.* For purposes of paragraph (c)(2)(i) of this section, benefits are disregarded if the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization's taxable year is not more than 2% of the amount of the payment. If the aggregate fair market value of the benefits exceeds 2% of the amount of the payment, then (except as provided in paragraph (c)(2)(iv) of this section) the entire fair market value of such benefits, not merely the excess amount, is a substantial return benefit. Fair market value is determined as provided in paragraph (d)(1) of this section.

(iii) *Benefits defined.* For purposes of this section, benefits provided to the payor or persons designated by the payor may include:

(A) Advertising as defined in paragraph (c)(2)(v) of this section.

(B) Exclusive provider arrangements as defined in paragraph (c)(2)(vi)(B) of this section.

(C) Goods, facilities, services or other privileges.

(D) Exclusive or nonexclusive rights to use an intangible asset (*e.g.*, trademark, patent, logo, or designation) of the exempt organization.

(iv) *Use or acknowledgment.* For purposes of this section, a substantial return

benefit does not include the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in connection with the activities of the exempt organization. Use or acknowledgment does not include advertising as described in paragraph (c)(2)(v) of this section, but may include the following: exclusive sponsorship arrangements; logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company; a list of the payor's locations, telephone numbers, or Internet address; value-neutral descriptions, including displays or visual depictions, of the payor's product-line or services; and the payor's brand or trade names and product or service listings. Logos or slogans that are an established part of a payor's identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution, whether for free or remuneration, of a payor's product by the payor or the exempt organization to the general public at the sponsored activity is not considered an inducement to purchase, sell or use the payor's product for purposes of this section and, thus, will not affect the determination of whether a payment is a qualified sponsorship payment.

(v) *Advertising*. For purposes of this section, the term *advertising* means any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product. A single message that contains both advertising and an acknowledgment is advertising. This section does not apply to activities conducted by a payor on its own. For example, if a payor purchases broadcast time from a television station to advertise its product during commercial breaks in a sponsored program, the exempt organization's activities are not thereby converted to advertising.

(vi) *Exclusivity arrangements*—(A) *Exclusive sponsor*. An arrangement that acknowledges the payor as the exclusive sponsor of an exempt organization's activity, or the exclusive sponsor representing a particular trade, business or industry, generally does not, by itself, result in a substantial return benefit. For example, if in exchange for a payment, an organization announces that its event is sponsored exclusively by the payor (and does not provide any advertising or other substantial return benefit to the payor), the payor has not received a substantial return benefit.

(B) *Exclusive provider*. An arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity generally results in a substantial return benefit. For example, if in exchange for a payment, the exempt organization agrees to allow only the payor's products to be sold in connection with an activity, the payor has received a substantial return benefit.

(d) *Allocation of payment*—(1) *In general*. If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment. However, if the exempt organization does not establish that the payment exceeds the fair market value of any substantial return benefit, then no portion of the payment constitutes a qualified sponsorship payment.

(i) *Treatment of payments other than qualified sponsorship payments*. The unrelated business income tax (UBIT) treatment of any payment (or portion thereof) that is not a qualified sponsorship payment is determined by application of sections 512, 513, and 514. For example, payments related to an exempt organization's providing facilities, services, or other privileges to the payor or persons designated by the payor, advertising, exclusive provider arrangements described in paragraph (c)(2)(vi)(B) of this section, a license to use intangible assets of the exempt organization, or other substantial return benefits, are evaluated separately in determining whether the exempt organization realizes unrelated business taxable income.

(ii) *Fair market value*. The fair market value of any substantial return benefit provided as part of a sponsorship arrangement is the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement and both having reasonable knowledge of relevant facts, and without regard to any other aspect of the sponsorship arrangement.

(iii) *Valuation date*. In general, the fair market value of the substantial return benefit is determined when the benefit is provided. However, if the parties enter into a binding, written sponsorship contract, the fair market value of any substantial return benefit provided pursuant to that contract is determined on the date the parties enter into the sponsorship contract. If the parties make a material change to a sponsorship contract, it is treated as a new sponsorship contract as of the date the material change is effective. A material change includes an extension or renewal of the contract, or a more than incidental change to any amount payable (or other consideration) pursuant to the contract.

(iv) *Examples*. The following examples illustrate the provisions of this section:

Example 1. On June 30, 2001, a national corporation and Z, a charitable organization, enter into a five-year binding, written contract effective for years 2002 through 2007. The contract provides that the corporation will make an annual payment of $5,000 to Z, and in return the corporation will receive no benefit other than advertising. On June 30, 2001, the fair market value of the advertising to be provided to the corporation in each year of the agreement is $75, which is less than the disregarded benefit amount provided for in paragraph (c)(2)(ii) of this section (2% of $5,000 is $100). In 2002, pursuant to the sponsorship contract, the corporation makes a payment to Z of $5,000, and receives the specified benefit (advertising). As of January 1, 2002, the fair market value of the advertising to be provided by Z each year has increased to $110. However, for purposes of this section, the fair market value of the advertising benefit is determined on June 30, 2001, the date the parties entered into the sponsorship contract. Therefore, the entire $5,000 payment received in 2002 is a qualified sponsorship payment.

Example 2. The facts are the same as *Example 1*, except that the contract provides for an initial payment by the corporation to Z of $5,000 in 2002, followed by annual payments of $1,000 during each of years 2003–2007. In 2003, pursuant to the sponsorship contract, the corporation makes a payment to Z of $1,000, and receives the specified advertising benefit. In 2003, the fair market value of the benefit provided ($75, as determined on June 30, 2001) exceeds 2% of the total payment received (2% of

$1,000 is $20). Therefore, only $925 of the $1,000 payment received in 2003 is a qualified sponsorship payment.

(2) *Anti-abuse provision*. To the extent necessary to prevent avoidance of the rule stated in paragraphs (d)(1) and (c)(2) of this section, where the exempt organization fails to make a reasonable and good faith valuation of any substantial return benefit, the Commissioner (or the Commissioner's delegate) may determine the portion of a payment allocable to such substantial return benefit and may treat two or more related payments as a single payment.

(e) *Special rules*—(1) *Written agreements*. The existence of a written sponsorship agreement does not, in itself, cause a payment to fail to be a qualified sponsorship payment. The terms of the agreement, not its existence or degree of detail, are relevant to the determination of whether a payment is a qualified sponsorship payment. Similarly, the terms of the agreement and not the title or responsibilities of the individuals negotiating the agreement determine whether a payment (or any portion thereof) made pursuant to the agreement is a qualified sponsorship payment.

(2) *Contingent payments*. The term *qualified sponsorship payment* does not include any payment the amount of which is contingent, by contract or otherwise, upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity. The fact that a payment is contingent upon sponsored events or activities actually being conducted does not, by itself, cause the payment to fail to be a qualified sponsorship payment.

(3) *Determining public support*. Qualified sponsorship payments in the form of money or property (but not services) are treated as contributions received by the exempt organization for purposes of determining public support to the organization under section 170(b)(1)(A)(vi) or 509(a)(2). See §§ 1.509(a)–3(f)(1) and 1.170A–9(e)(6)(i). The fact that a payment is a qualified sponsorship payment that is treated as a contribution to the payee organization does not determine whether the payment is deductible by the payor under section 162 or 170.

(f) *Examples*. The provisions of this section are illustrated by the following examples. The tax treatment of any payment (or portion of a payment) that does not constitute a qualified sponsorship payment is governed by general UBIT principles. In these examples, the recipients of the payments at issue are section 501(c) organizations. The expectations or arrangements of the parties are those specifically indicated in the example. The examples are as follows:

Example 1. M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to winners of the event. M recognizes the assistance of the corporation by listing the corporation's name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M's activities constitute acknowledgment of the sponsorship. The drinks, refreshments and prizes provided by the corporation are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 2. N, an art museum, organizes an exhibition and receives a large payment from a corporation to help fund the exhibition. N recognizes the corporation's support by using the corporate name and established logo in materials publicizing the exhibition, which include banners, posters, brochures and public service announcements. N also hosts a dinner for the corporation's executives. The fair market value of the dinner exceeds 2% of the total payment. N's use of the corporate name and logo in connection with the exhibition constitutes acknowledgment of the sponsorship. However, because the fair market value of the dinner exceeds 2% of the total payment, the dinner is a substantial return benefit. Only that portion of the payment, if any, that N can demonstrate exceeds the fair market value of the dinner is a qualified sponsorship payment.

Example 3. O coordinates sports tournaments for local charities. An auto manufacturer agrees to underwrite the expenses of the tournaments. O recognizes the auto manufacturer by including the manufacturer's name and established logo in the title of each tournament as well as on signs, scoreboards and other printed material. The auto manufacturer receives complimentary admission passes and pro-am playing spots for each tournament that have a combined fair market value in excess of 2% of the total payment. Additionally, O displays the latest models of the manufacturer's premier luxury cars at each tournament. O's use of the manufacturer's name and logo and display of cars in the tournament area constitute acknowledgment of the sponsorship. However, the admission passes and pro-am playing spots are a substantial return benefit. Only that portion of the payment, if any, that O can demonstrate exceeds the fair market value of the admission passes and pro-am playing spots is a qualified sponsorship payment.

Example 4. P conducts an annual college football bowl game. P sells to commercial broadcasters the right to broadcast the bowl game on television and radio. A major corporation agrees to be the exclusive sponsor of the bowl game. The detailed contract between P and the corporation provides that in exchange for a $1,000,000 payment, the name of the bowl game will include the name of the corporation. In addition, the contract provides that the corporation's name and established logo will appear on player's helmets and uniforms, on the scoreboard and stadium signs, on the playing field, on cups used to serve drinks at the game, and on all related printed material distributed in connection with the game. P also agrees to give the corporation a block of game passes for its employees and to provide advertising in the bowl game program book. The fair market value of the passes is $6,000, and the fair market value of the program advertising is $10,000. The agreement is contingent upon the game being broadcast on television and radio, but the amount of the payment is not contingent upon the number of people attending the game or the television ratings. The contract provides that television cameras will focus on the corporation's name and logo on the field at certain intervals during the game. P's use of the corporation's name and logo in connection with the bowl game constitutes acknowledgment of the sponsorship. The exclusive sponsorship arrangement is not a substantial return benefit. Because the fair market value of the game passes and program advertising ($16,000) does not exceed 2% of the total payment (2% of $1,000,000 is $20,000), these benefits are disregarded and the entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 5. Q organizes an amateur sports team. A major pizza chain gives uniforms to players on Q's team, and also pays some of the team's operational expenses. The uniforms bear the name and established logo of the pizza chain. During the final tournament series, Q distributes free of charge souvenir flags bearing Q's name to employees of the pizza chain who come out to support the team. The flags are valued at less than 2% of the combined fair market value of the uniforms and operational expenses paid. Q's use of the name and logo of the pizza chain in connection with the tournament constitutes acknowledgment of the sponsorship. Because the fair market value of the flags does not exceed 2% of the total payment, the entire amount of the funding and supplied uniforms are a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 6. R is a liberal arts college. A soft drink manufacturer enters into a binding, written contract with R that provides for a large payment to be made to the college's English department in exchange for R agreeing to name a writing competition after the soft drink manufacturer. The contract also provides that R will allow the soft drink manufacturer to be the exclusive provider of all soft drink sales on campus. The fair market value of the exclusive provider component of the contract exceeds 2% of the total payment. R's use of the manufacturer's name in the writing competition constitutes acknowledgment of the sponsorship. However, the exclusive provider arrangement is a substantial return benefit. Only that portion of the payment, if any, that R can demonstrate exceeds the fair market value of the exclusive provider arrangement is a qualified sponsorship payment.

Example 7. S is a noncommercial broadcast station that airs a program funded by a local music store. In exchange for the funding, S broadcasts the following message: "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 555–1234. This station is proud to have the Music Shop as a sponsor." Because this single broadcast message contains both advertising and an acknowledgment, the entire message is advertising. The fair market value of the advertising exceeds 2% of the total payment. Thus, the advertising is a substantial return benefit. Unless S establishes that the amount of the payment exceeds the fair market value of the advertising, none of the payment is a qualified sponsorship payment.

Example 8. T, a symphony orchestra, performs a series of concerts. A program guide that contains notes on guest conductors and other information concerning the evening's program is distributed by T at each concert. The Music Shop makes a $1,000 payment to T in support of the concert series. As a supporter of the event, the Music Shop receives complimentary concert tickets with a fair market value of $85, and is recognized in the program guide and on a poster in the lobby of the concert hall. The lobby poster states that, "The T concert is sponsored by the Music Shop, located at 123 Main Street, telephone number 555–1234." The program guide contains the same information and also states, "Visit the Music Shop today for the finest selection of music CDs and cassette tapes." The fair market value of the advertisement in the program guide is $15. T's use of the Music Shop's name, address, and telephone number in the lobby poster constitutes acknowledgment of the sponsorship. However, the combined fair market value of the advertisement in the program guide and complimentary tickets is $100 ($15 + $85), which exceeds 2% of the total payment (2% of $1,000 is $20). The fair market value of the advertising and complimentary tickets, therefore, constitutes a substantial return benefit and only that portion of the payment, or $900, that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment.

Example 9. U, a national charity dedicated to promoting health, organizes a campaign to inform the public about potential cures to fight a serious disease. As part of the campaign, U sends representatives to community health fairs around the country to answer questions about the disease and inform the public about recent developments in the search for a cure. A pharmaceutical company makes a payment to U to fund U's booth at a health fair. U places a sign in the booth displaying the pharmaceutical company's name and slogan, "Better Research, Better Health," which is an established part of the company's identity. In addition, U grants the pharmaceutical company a license to use U's logo in marketing its products to health care providers around the country. The fair market value of the license exceeds 2% of the total payment received from the company. U's display of the pharmaceutical company's name and slogan constitutes acknowledgment of the sponsorship. However, the license granted to the pharmaceutical company to use U's logo is a substantial return benefit. Only that portion of the payment, if any, that U can demonstrate exceeds the fair market value of the license granted to the pharmaceutical company is a qualified sponsorship payment.

Example 10. V, a trade association, publishes a monthly scientific magazine for its members containing information about current issues and developments in the field. A textbook publisher makes a large payment to V to have its name displayed on the inside cover of the magazine each month. Because the monthly magazine is a periodical within the meaning of paragraph (b) of this section, the section 513(i) safe harbor does not apply. See § 1.512(a)–1(f).

Example 11. W, a symphony orchestra, maintains a website containing pertinent information and its performance schedule. The Music Shop makes a payment to W to fund a concert series, and W posts a list of its sponsors on its website, including the Music Shop's name and Internet address. W's website does not promote the Music Shop or advertise its merchandise. The Music Shop's Internet address appears as a hyperlink from W's website to the Music Shop's website. W's posting of the Music Shop's name and Internet address on its website constitutes acknowledgment of the sponsorship. The entire payment is a qualified sponsorship payment, which is not income from an unrelated trade or business.

Example 12. X, a health-based charity, sponsors a year-long initiative to educate the public about a particular medical condition. A large pharmaceutical company manufactures a drug that is used in treating the medical condition, and provides funding for the initiative that helps X produce educational materials for distribution and post information on X's website. X's website contains a hyperlink to the pharmaceutical company's website. On the pharmaceutical company's website, the statement appears, "X endorses the use of our drug, and suggests that you ask your doctor for a prescription if you have this medical condition." X reviewed the endorsement before it was posted on the pharmaceutical company's website and gave permission for the endorsement to appear. The endorsement is advertising. The fair market value of the advertising exceeds 2% of the total payment received from the pharmaceutical company. Therefore, only the portion of the payment, if any, that X can demonstrate exceeds the fair market value of the advertising on the pharmaceutical company's website is a qualified sponsorship payment.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 12, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 24, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 25, 2002, 67 F.R. 20433)

Section 1012.—Basis of Property—Cost

26 CFR 1.1012–1: Basis of property.

Under the CCR method of accounting, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle. See Rev. Proc. 2002–36, page 993.

Section 6050S.— Returns Relating to Higher Education Tuition and Related Expenses

26 CFR 1.6050S–2T: Electronic furnishing of information statements for qualified tuition and related expenses (temporary).

T.D. 8992

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301, and 602

Information Reporting for Payments of Interest on Qualified Education Loans; Magnetic Media Filing Requirements for Information Returns

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the information reporting requirements under section 6050S for payments of interest on qualified education loans, including the filing of information returns on magnetic media. The final regulations reflect changes to the law made by the Taxpayer Relief Act of 1997. The regulations provide guidance to payees receiving interest payments on qualified education loans.

DATES: *Effective date*: These regulations are effective April 29, 2002.

Applicability date: For date of applicability, see § 1.6050S–3(g).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Donna Welch, (202) 622–4910; and concerning the magnetic media filing specifications, waivers for filing on magnetic media, and extensions of time, contact the Internal Revenue Service, Martinsburg Computing Center, (304) 263–8700 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1678. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Budget and Management.

The estimated burden for the reporting in these regulations is reflected in the burden for Form 1098–E.

Estimated total annual reporting burden for 2000 for Form 1098–E: 483,098 hours.

Estimated number of responses for 2000 for Form 1098–E: 9,661,965.

Estimated average annual burden hours per response for Form 1098–E: 3 minutes.

Comments concerning the accuracy of this burden and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to information reporting requirements under section 6050S. The Taxpayer Relief Act of 1997 (Public Law 105–34 (111 Stat. 788) (TRA '97)) added section 221 of the Internal Revenue Code (Code) to allow certain taxpayers who pay interest on qualified education loans to claim a Federal income tax deduction for their interest payments. In general, as enacted by TRA '97, a deduction is allowed for interest payments made during the first 60 months in which interest payments are required on a qualified education loan. However, no interest deduction is allowed for any interest paid before January 1, 1998. On January 21, 1999, the IRS issued proposed regulations (REG–116826–97, 1999–1 C.B. 701) under section 221. See 64 FR 3257 (1999). Section 221 was amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107–16 (115 Stat. 38)) to eliminate the limitation on the number of months during which interest paid on a qualified education loan is deductible, effective for interest paid after December 31, 2001, and to allow a deduction for voluntary payments of interest.

TRA '97 also added section 25A of the Code to provide the Hope Scholarship Credit and the Lifetime Learning Credit (education tax credit). In general, the education tax credit allows certain taxpayers who pay qualified tuition and related expenses to an eligible educational institution to claim a nonrefundable credit against their Federal income tax liability. On January 6, 1999, the IRS issued proposed regulations (REG–106388–98, 1999–1 C.B. 756) under section 25A. See 64 FR 794 (1999).

In addition, TRA '97 added section 6050S of the Code. Section 6050S was amended by the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105–206 (112 Stat. 685) (RRA '98)) and Public Law 107–131 (115 Stat. 2410). In general, section 6050S requires certain payees who receive payments of interest on one or more qualified education loans to file information returns and to furnish written information statements to assist taxpayers and the IRS in determining any interest deduction allowable under section 221. In addition, section 6050S requires eligible educational institutions to file information returns and to furnish written information statements to assist taxpayers and the IRS in determining any education tax credit allowable under section 25A (as well as other tax benefits for higher education expenses). See H.R. Conf. Rept. No. 599, 105th Cong., 2d Sess., pp. 319–320 (1998). Similarly, section 6050S requires any person engaged in a trade or business of making payments to any individual under an insurance agreement as reimbursements or refunds of qualified tuition and related expenses to file information returns and to furnish written information statements.

Section 6050S(b) provides that the information return filed by payees who receive payments of interest on qualified education loans must contain: (1) the name, address, and taxpayer identification number (TIN) of the individual with respect to whom payments of interest on qualified education loans were received; (2) the aggregate amount of interest received for the calendar year from such individual; and (3) such other information as the Secretary may prescribe.

The IRS has published several notices describing the information reporting requirements for payees who receive interest on qualified education loans during the years 1998, 1999, 2000, and 2001. See Notice 98–7 (1998–1 C.B. 339), Notice 98–54 (1998–2 C.B. 641), Notice 99–37 (1999–2 C.B. 124), and Notice 2000–62 (2000–2 C.B. 587).

A notice of proposed rulemaking under section 6050S (REG–105316–98, 2000–2 C.B. 98) was published in the **Federal Register** (65 FR 37728) on June 16, 2000, addressing the information reporting requirements for eligible educational institutions and insurers and payees who receive interest on qualified education loans. A public hearing was held on the proposed regulations on February 13, 2001. The IRS received written and electronic comments responding to the notice of proposed rulemaking.

The IRS and the Treasury Department have determined that the proposed regulations in § 1.6050S–1 addressing the information reporting requirements for eligible educational institutions and insurers

should be withdrawn and that new proposed regulations should be issued. The IRS will issue proposed regulations in § 1.6050S–1 in a separate document. The proposed regulations in § 1.6050S–2 addressing the information reporting requirements for payees who receive payments of interest on qualified education loans are adopted as amended by this Treasury decision and redesignated as § 1.6050S–3. The comments received in connection with these regulations and the revisions are discussed in the "Explanation of Provisions and Summary of Comments" of this preamble.

Temporary regulations (66 FR 10191) and a notice of proposed rulemaking by cross reference (REG–107186–00, 2001–1 C.B. 973) (66 FR 10247) under section 6050S were published in the **Federal Register** on February 14, 2001. Those regulations allow eligible educational institutions and payees who receive interest on qualified education loans to furnish information statements electronically to students and borrowers, respectively, if certain requirements are met. The temporary regulations for eligible educational institutions were designated as § 1.6050S–1T, and the temporary regulations for payees were designated as § 1.6050S–2T. The IRS and the Treasury Department have determined that those regulations should be finalized in a separate document. However, this Treasury decision redesignates § 1.6050S–1T and § 1.6050S–2T as § 1.6050S–2T and § 1.6050S–4T, respectively.

Explanation of Provisions and Summary of Comments

1. Information Reporting for Payments of Interest on Qualified Education Loans

The proposed regulations require any person engaged in a trade or business that receives from any payor interest of $600 or more for any calendar year on one or more qualified education loans (as defined in section 221(e)(1) and the regulations thereunder) (a payee) to file a Form 1098–E, *Student Loan Interest Statement*, with the IRS. Under the proposed regulations, a payee must report the name, address, and taxpayer identification number (TIN) of the payee; the name, address, and TIN of the payor; and the aggregate amount of interest received during the calendar year from the payor. The final regulations retain these rules. As explained in the preamble to the proposed regulations, a payee may be the lender, the holder of the loan, or the loan servicer.

Consistent with TRA '97, the proposed regulations provide that a payee is required to report interest payments received on a qualified education loan during only the first 60 months in which interest payments are required on the loan. The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the limitation on the number of months during which interest paid on a qualified education loan is deductible, effective for interest paid after December 31, 2001. Therefore, the final regulations eliminate the 60-month reporting period, so that payees must continue to report annually interest payments on qualified education loans.

A. *Section 221 comments*

The proposed regulations provide that, in determining the aggregate amount of interest payments to be reported by a payee, the term *interest* includes stated interest, loan origination fees (other than any fees for services), and capitalized interest as described in the regulations under section 221. Several commentators requested that other fees, such as insurance, be treated as deductible interest for purposes of section 221. In addition, several commentators requested clarification of, or changes to, the manner in which payments are allocated to interest, the definition of *qualified education loans*, and the ability to estimate capitalized interest. These comments were not considered in these regulations, which address only the information reporting requirements for interest payments on qualified education loans under section 221, but the comments will be considered in finalizing the regulations under section 221.

B. *Reporting of interest received or collected by one or more persons*

Section 6050S(f) requires that, in the case of any person who receives any amount on behalf of another person, only the first person receiving the amount is required to comply with the information reporting requirements. Based on section 6050S(f), the proposed regulations provide that if a payee contracts with another person to receive or collect interest payments on a qualified education loan on its behalf, the other person must comply with the information reporting requirements. Commentators requested clarification of how this rule would apply if a payee contracts with multiple parties, such as a billing service and a collection agent. Other commentators requested clarification of the rule for noncontractual arrangements and how the rule would apply if the person receiving the payments does not ordinarily possess the payor information required to file information returns (*e.g.*, a lock-box agent, a bankruptcy trustee, or a collection agency). The commentators suggested that the regulations provide that if a person collects or receives payments on a qualified loan on behalf of another person (whether or not a formal contract exists), the person collecting or receiving the payments must satisfy the reporting requirements, unless the other person does not possess the information needed to comply with the reporting requirements. This recommendation is consistent with the provisions of section 6050H and the regulations thereunder; therefore, the final regulations adopt this recommendation.

C. *Forms 1098–E filed by third-party*

Several commentators requested that the final regulations permit a payee to contract with a third party to file Forms 1098–E, *Student Loan Interest Statement*, and to furnish the information statements. The general instructions to Form 1099 and Form 1098 allow a filing agent if certain requirements are met. Therefore, the final regulations do not need to adopt this recommendation.

D. *Information statement*

Several commentators requested that the final regulations eliminate the requirement that a payee furnish certain instructions to a payor with the information statement. The commentators explained that the instructional language implies that the payee is able to provide tax assistance. The instructions that a payee is required to furnish with the information statement alert the payor to the limitations

on the deductibility of reported interest. In addition, the instructions clearly state that the payor should refer to the IRS forms and publications for information regarding the deductibility of reported interest. Therefore, the final regulations do not eliminate the required instructions; however, the regulations clarify that the payor should refer to the IRS forms and publications, and not the payee, for tax information.

The proposed regulations provide that the information statement must include the name, address, and phone number of the individual who is the information contact for the payee that filed the Form 1098–E. It is often not feasible for payees to identify a specific individual as the information contact. Therefore, the final regulations provide that the information statement must include the name, address, and phone number of an office or department of the payee as the information contact.

E. *Payment adjustments after returns filed*

Other commentators requested that the final regulations provide specific rules for reporting interest payment adjustments made after information returns have been filed with the IRS. The commentators stated that requiring reporting of adjustments to interest previously reported would be overly burdensome. The final regulations do not need to include specific rules because additional interest payments received in a subsequent year that relate to interest payments reported in a prior year are reportable in the year of receipt. Further, a payee is not required to report reimbursements or refunds of interest payments previously reported. However, a payee should file corrected information returns to report interest payments that were incorrectly reported in a prior year.

F. *Effective date of regulations and continuation of Notice 98–7 for the calendar year 2002*

The proposed regulations provide that the regulations will apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2001. Several comments were received on the proposed effective date. Several commentators recommended that the final regulations apply to new loans made on or after January 1 of the year that is 24 months after publication of the final regulations and that loans made before that date remain subject to the requirements in Notice 98–7, as modified. Other comments requested a period of at least 12 months after publication of final regulations to make programming changes to implement required reporting with respect to loan origination fees and capitalized interest.

Further comments requested that the reporting requirements in Notice 98–7, as modified, continue for information returns required to be filed, and information statements required to be furnished, for interest payments received during calendar year 2002 (for which the returns and statements are required to be filed and furnished in 2003). In general, the final regulations do not impose any significant reporting requirement beyond the reporting currently required by Notice 98–7, as modified, and Form 1098–E. However, in response to comments, the IRS and the Treasury Department extend Notice 98–7, as modified, for the calendar year 2002. Therefore, the final regulations apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2003 (for interest payments received during calendar year 2003). In addition, in order to provide additional time for payees to implement reporting of loan origination fees and capitalized interest, the final regulations provide that a payee is not required to report payments of such amounts as interest for qualified education loans made before January 1, 2004.

2. *Requirement to File Information Returns on Magnetic Media*

The final regulations amend the regulations under section 6011(e) to require payees who are required to file 250 or more Forms 1098–E to file on magnetic media.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. A final regulatory flexibility analysis has been prepared for the collection of information in this Treasury decision. This analysis is set forth in this preamble under the heading "Final Regulatory Flexibility Analysis." Pursuant to section 7805(f), the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Final Regulatory Flexibility Analysis

The collection of information contained in § 1.6050S–3 is needed to assist the IRS and taxpayers in determining the amount of any interest deduction allowable under section 221. The objectives of these regulations are to provide uniform, practicable, and administrable rules under section 6050S. The types of small entities to which the regulations may apply are certain payees (*e.g.*, a lender, a holder of the loan, or a loan servicer) who receive interest payments of $600 or more on qualified education loans.

There are no known Federal rules that duplicate, overlap, or conflict with these regulations. The regulations are considered to have the least economic impact on small entities of all alternatives considered.

Moreover, the regulations requiring filing Forms 1098–E on magnetic media impose no additional reporting or recordkeeping and only prescribe the method of filing information returns that are already required to be filed. Further, these regulations are consistent with the statutory requirement that a payee is not required to file Forms 1098–E on magnetic media unless required to file at least 250 or more returns during the year. Finally, the economic impact caused by requiring Forms 1098–E on magnetic media should be minimal because most payee's operations are computerized. Even if their operations are not computerized, the incremental cost of magnetic media reporting should be minimal in most cases because of the availability of computer service bureaus. In addition, the existing regulations under section 6011(e) provide that the IRS may waive the magnetic media filing requirements on a

showing of hardship. The waiver authority will be exercised so as not to unduly burden payees lacking both the necessary data processing facilities and access at a reasonable cost to computer service bureaus.

Drafting Information

The principal author of the regulations is Donna Welch, Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301, and 602 are amended as follows:

PART 1—INCOME TAX

Paragraph 1. The authority citation for part 1 is amended by removing the entry for "Section 1.6050S–1T" and by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.6050S–3 also issued under 26 U.S.C. 6050S(g).

Section 1.6050S–4T also issued under 26 U.S.C. 6050S(g). * * *

Par. 2. Sections 1.6050–1T and 1.6050S–2T are redesignated as §§ 1.6050S–2T and 1.6050S–4T, respectively, and amended by revising the section headings to read as follows:

§ 1.6050S–2T Electronic furnishing of information statements for qualified tuition and related expenses (temporary).

* * * * *

§ 1.6050S–4T Electronic furnishing of information statements for payments of interest on qualified education loans (temporary).

* * * * *

Par. 3. Sections 1.6050S–0 and 1.6050S–3 are added to read as follows:

§ 1.6050S–0 Table of contents

This section lists captions contained in section 6050S.

§ 1.6050S–2T Electronic furnishing of information statements for qualified tuition and related expenses.

§ 1.6050S–3 Information reporting for payments of interest on qualified education loans.

§ 1.6050S–4T Electronic furnishing of information statements for payments of interest on qualified education loans.

§ 1.6050S–3 Information reporting for payments of interest on qualified education loans.

(a) *Information reporting requirement in general.* Except as otherwise provided

in this section, any person engaged in a trade or business that, in the course of that trade or business, receives from any payor (as defined in paragraph (b)(2) of this section) interest payments that aggregate $600 or more for any calendar year on one or more qualified education loans (as defined in section 221(e)(1) and the regulations thereunder)(a payee) must—

(1) File an information return, as described in paragraph (c) of this section, with the Internal Revenue Service with respect to the payor; and

(2) Furnish a statement, as described in paragraph (d) of this section, to the payor.

(b) *Definitions*. The following definitions apply for purposes of this section:

(1) *Interest. Interest* includes stated interest, loan origination fees (other than fees for services), and capitalized interest as described in the regulations under section 221. See paragraph (e)(1) of this section for a special transitional rule relating to reporting of loan origination fees and capitalized interest.

(2) *Payor. Payor* means the individual who is carried on the books and records of the payee as the borrower on a qualified education loan. If there are multiple borrowers, the principal borrower on the payee's books and records is treated as the payor for purposes of section 6050S and this section.

(c) *Requirement to file return*—(1) *Form of return*. A payee must file an information return for the payor on Form 1098–E, *Student Loan Interest Statement*. A payee may use a substitute for Form 1098–E if the substitute form complies with the applicable revenue procedures relating to substitute forms.

(2) *Information included on return*. A payee must include on Form 1098–E—

(i) The name, address, and taxpayer identification number (TIN)(as defined in section 7701(a)(41)) of the payee;

(ii) The name, address, and TIN of the payor;

(iii) The aggregate amount of interest payments received during the calendar year from the payor; and

(iv) Any other information required by Form 1098–E and its instructions.

(3) *Time and place for filing return*—(i) *In general*. Except as provided in paragraph (c)(3)(ii) of this section, the Form 1098–E must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which interest payments were received. A payee must file Form 1098–E with the Internal Revenue Service according to the instructions to Form 1098–E.

(ii) *Extensions of time*. The Internal Revenue Service may grant a payee an extension of time to file returns required in this section upon a showing of good cause. See the instructions to Form 1098–E and applicable revenue procedures for rules relating to extensions of time to file.

(4) *Use of magnetic media*. See section 6011(e) and § 301.6011–2 of this chapter for rules relating to the requirement to file Forms 1098–E on magnetic media.

(d) *Requirement to furnish statement*—(1) *In general*. A payee must furnish a statement to each payor for whom it is required to file a Form 1098–E. The statement must include—

(i) The information required under paragraph (c)(2) of this section;

(ii) A legend that identifies the statement as important tax information that is being furnished to the Internal Revenue Service;

(iii) Instructions that—

(A) State that, under section 221 and the regulations thereunder, the payor may not be able to deduct the full amount of interest reported on the statement;

(B) In the case of qualified education loans made before January 1, 2004, for which the payee does not report payments of interest other than stated interest, state that the payor may be able to deduct additional amounts (such as certain loan origination fees and capitalized interest) not reported on the statement;

(C) State that the payor should refer to relevant Internal Revenue Service forms and publications, and should not refer to the payee, for explanations relating to the eligibility requirements for, and calculation of, any allowable deduction for interest paid on a qualified education loan; and

(D) Include the name, address, and phone number of the office or department of the payee that is the information contact for the payee that filed the Form 1098–E.

(2) *Time and manner for furnishing statement*—(i) *In general*. Except as provided in paragraph (d)(2)(ii) of this section, a payee must furnish the statement described in paragraph (d)(1) of this section to the payor on or before January 31 of the year following the calendar year in which payments of interest on a qualified education loan were received. If mailed, the statement must be sent to the payor's last known address. If furnished electronically, the statement must be furnished in accordance with the applicable regulations.

(ii) *Extensions of time*. The Internal Revenue Service may grant a payee an extension of time to furnish statements required in this section upon a showing of good cause. See the instructions to Form 1098–E and applicable revenue procedures for rules relating to extensions of time to furnish statements.

(3) *Copy of Form 1098–E*. A payee may satisfy the requirement of this paragraph (d) by furnishing either a copy of Form 1098–E and its instructions or another document that contains all the information filed with the Internal Revenue Service and the information required by paragraph (d)(1) of this section if the document complies with applicable revenue procedures relating to substitute statements.

(e) *Special rules*—(1) *Transitional rule for reporting of loan origination fees and capitalized interest*. For qualified education loans made before January 1, 2004, a payee is not required to report payments of loan origination fees and capitalized interest as interest under section 6050S and this section.

(2) *Qualified education loan certification*. If a loan is not subsidized, guaranteed, financed, or is not otherwise treated as a student loan under a program of the Federal, state, or local government or an eligible educational institution, a payee must request a certification from the payor that the loan will be used solely to pay for qualified higher education expenses. A payee may use Form W–9S, *Request for Student's or Borrower's Social Security Number and Certification*, to obtain the certification. A payee may establish an electronic system for payors to submit Forms W–9S electronically as described in applicable forms and instructions. A payee may also develop a separate form to obtain the payor certification or may incorporate the certification into other forms customarily used by the payee, such as loan applications, provided

the certification is clearly set forth. If the certification is not received, the loan is not a qualified education loan for purposes of section 6050S and this section.

(3) *Payments of interest received or collected by one or more persons*—(i) *In general*. Except as otherwise provided in paragraph (e)(3)(ii) of this section, if a person collects or receives payments of interest on a qualified education loan on behalf of another person (*e.g.*, a lender), the person collecting or receiving the interest must satisfy the information reporting requirements of this section. In this case, the reporting requirements do not apply to the transfer of interest to the other person.

(ii) *Exception*. If the person collecting or receiving payments of interest on a qualified education loan on behalf of another person (*e.g.*, a lender) does not possess the information needed to comply with the information reporting requirements of this section, the other person must satisfy the information reporting requirements of this section.

(4) *Reporting by foreign persons*. A payee that is not a United States person (as defined in section 7701(a)(30)) must report payments of interest it receives on a qualified education loan only if it receives the payment—

(i) At a location in the United States; or

(ii) At a location outside the United States if the payee is—

(A) A controlled foreign corporation (within the meaning of section 957(a)); or

(B) A person 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of the taxable year preceding the taxable year in which interest payments were received (or for such part of the period as the person was in existence), was effectively connected with the conduct of a trade or business within the United States.

(5) *Governmental units*. A governmental unit, or an agency or instrumentality of a governmental unit, that receives from any payor interest payments that aggregate $600 or more for any calendar year on one or more qualified education loans is a payee, without regard to the requirement of paragraph (a) of this section that the interest be received in the course of a trade or business.

(f) *Penalty provisions*—(1) *Failure to file correct returns*. The section 6721 penalty may apply to a payee that fails to file information returns required by section 6050S and this section on or before the required filing date; that fails to include all of the required information on the return; or that includes incorrect information on the return. See section 6721, and the regulations thereunder, for rules relating to penalties for failure to file correct returns. See section 6724, and the regulations thereunder, for rules relating to waivers of penalties for certain failures due to reasonable cause.

(2) *Failure to furnish correct information statements*. The section 6722 penalty may apply to a payee that fails to furnish statements required by section 6050S and this section on or before the prescribed date; that fails to include all the required information on the statement; or that includes incorrect information on the statement. See section 6722, and the regulations thereunder, for rules relating to penalties for failure to furnish correct statements. See section 6724, and the regulations thereunder, for rules relating to waivers of penalties for certain failures due to reasonable cause.

(3) *Waiver of penalties for failures to include a correct TIN*—(i) *In general*. In the case of a failure to include a correct TIN on Form 1098–E or a related information statement, penalties may be waived if the failure is due to reasonable cause. Reasonable cause may be established if the failure arose from events beyond the payee's control, such as a failure of the payor to furnish a correct TIN. However, the payee must establish that it acted in a responsible manner both before and after the failure.

(ii) *Acting in a responsible manner*. A payee must request the TIN of each payor if it does not already have a record of the payor's correct TIN. If the payee does not have a record of the payor's correct TIN, then it must solicit the TIN in the manner described in paragraph (f)(3)(iii) of this section on or before December 31 of each year during which it receives payments of interest. If a payor refuses to provide his or her TIN upon request, the payee must file the return and furnish the statement required by this section without the payor's TIN, but with all other required information. The specific solicitation requirements of paragraph (f)(3)(iii) of this section apply in lieu of the solicitation requirements of § 301.6724–1(e) and (f) of this chapter for the purpose of determining whether a payee acted in a responsible manner in attempting to obtain a correct TIN. A payee that complies with the requirements of this paragraph (f)(3) will be considered to have acted in a responsible manner within the meaning of § 301.6724–1(d) of this chapter with respect to any failure to include the correct TIN of a payor on a return or statement required by section 6050S and this section.

(iii) *Manner of soliciting TIN*. A payee must request the payor's TIN in writing and must clearly notify the payor that the law requires the payor to furnish a TIN so that it may be included on an information return filed by the payee. A request for a TIN made on Form W–9S, *Request for Student's or Borrower's Social Security Number and Certification*, satisfies the requirements of this paragraph (f)(3)(iii). A payee may establish a system for payors to submit Forms W–9S electronically as described in applicable forms and instructions. A payee may also develop a separate form to request the payor's TIN or incorporate the request into other forms customarily used by the payee, such as loan applications.

(4) *Failure to furnish TIN*. The section 6723 penalty may apply to any payor who is required (but fails) to furnish his or her TIN to a payee. See section 6723, and the regulations thereunder, for rules relating to the penalty for failure to furnish a TIN.

(g) *Effective date*. The rules in this section apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2003.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 5. Section 301.6011–2 is amended by:

1. Revising the first sentence of paragraph (b)(1).

2. Revising paragraph (g)(1).

3. Adding paragraph (g)(3).

The revisions and additions read as follows:

§ 301.6011–2 Required use of magnetic media.

* * * * *

(b) *Returns required on magnetic media*. (1) If the use of Forms 1042–S, 1098, 1098–E, 1099 series, 5498, 8027, W–2G, or other form treated as a form specified in this paragraph (b)(1) is required by the applicable regulations or revenue procedures for the purpose of making an information return, the information required by the form must be submitted on magnetic media, except as otherwise provided in paragraph (c) of this section. * * *

* * * * *

(g) *Effective dates*. (1) Except as otherwise provided in paragraph (g)(2) or (3) of this section, this section applies to returns required to be filed after December 31, 1986.

* * * * *

(3) This section applies to returns on Form 1098–E required to be filed after December 31, 2003.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In § 602.101, paragraph (b) is amended by removing the entry for "1.6050S–1T", and adding two new entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.6050S–3	1545–1678
1.6050S–4T	1545–1729
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 8, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 26, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 29, 2002, 67 F.R. 20901)

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2002–32

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73 (1988–2 C.B. 383) provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for April 2002 is 5.68 percent. Pursuant to Notice 2002–26 (2002–15 I.R.B. 743), the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
May	2002	5.69	5.12 to 6.25	5.12 to 6.82

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1–202–283–9888 (not a toll-free number).

Suspension of Requirement to File Form 8390 (*Information Return for Determination of Life Insurance Company Earnings Rate Under Section 809*)

Notice 2002–33

Section 809 of the Internal Revenue Code reduces the policyholder dividends that a mutual life insurance company is permitted to deduct under section 808. Each year, the Internal Revenue Service publishes the differential earnings rate (DER) and the recomputed differential earnings rate (RDER) to be used in computing the amount of the reduction. The DER and RDER are determined by the Service on the basis of information reported by mutual life insurance companies and the 50 largest stock life insurance companies (as determined by the Service) on Form 8390, *Information Return for Determination of Life Insurance Company Earnings Rate Under Section 809*.

The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107–147, § 611, amended section 809 of the Code by adding new paragraph (j). As amended, section 809(j) provides that the DER shall be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003.

As a result of this amendment to section 809, the Service will not be computing the DER and RDER for 2001, 2002, or 2003.* The determination of the 50 largest stock companies, however, will be made for those years.

The suspension of section 809 by section 809(j) expires in 2004. Accordingly, life insurance companies will not be required to file Form 8390 in either 2002 or 2003.

*Notice 2002–19 (2002–10 I.R.B. 619) provided that the tentative DER for 2001 and RDER for 2000 are zero.

The Service will be required to compute a 2004 DER and RDER using prior year income information from both stock and mutual life insurance companies. Therefore, it is expected that the requirement that companies file Form 8390 will be reinstated in 2004. Mutual life insurance companies will be required to file a Form 8390 with respect to calendar years 2002 and 2003. Any stock life insurance company that is determined to be one of the 50 largest stock life insurance companies during 2001, 2002, or 2003 will be required to file a Form 8390 with respect to that year. All life insurance companies that may be required to report 2001, 2002, or 2003 information are obligated to retain the records necessary to report the appropriate information in 2004.

Life insurance companies that will be required to file a Form 8390 with respect to calendar years 2001 or 2002 will be required to file such form no later than July 1, 2004. Life insurance companies that will be required to file a Form 8390 with respect to calendar year 2003 will be required to file such form no later than October 1, 2004.

When filing Form 1120–L (*U.S. Life Insurance Company Income Tax Return*) for 2001, mutual life insurance companies should treat the DER as zero for purposes of computing the differential earnings amount in Schedule C (*Differential Earnings Amount*). Appropriate changes will be made to Form 1120–L for 2002.

For 2004 and years thereafter, the Service will issue additional guidance regarding the filing of Form 8390 by life insurance companies as needed.

Comments are requested on the implementation of section 809(j), the requirement that information with respect to 2001 and 2002 and information with respect to 2003 be filed separately, and any required changes to Form 1120–L (such as temporarily eliminating Schedule C). Comments should be sent to CC:ITA:RU (Notice 2002–33), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (Notice 2002–33), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. In the alternative, e-mail comments to *Notice.Comments@irscounsel.treas.gov*.

DRAFTING INFORMATION

The principal author of this notice is Katherine A. Hossofsky of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Ms. Hossofsky at 202–622–3477 (not a toll-free call).

IRS Announces Voluntary Compliance Program to Promote Disclosure by Political Organizations

Notice 2002–34

The Internal Revenue Service (IRS) announces a voluntary compliance program to promote disclosure by political organizations described in § 527 of the Internal Revenue Code (political organizations) that file certain forms by **July 15, 2002**.

BACKGROUND

On July 1, 2000, Pub. L. 106–230 was enacted, imposing new reporting and disclosure requirements on political organizations in connection with their tax-exempt status. The IRS is aware that there is a great deal of confusion concerning the new filing requirements. Because of this confusion, many political organizations have either failed to file or need to correct previously filed forms. The IRS believes that implementing this voluntary compliance program for these political organizations is most likely to achieve the congressional goal of maximum disclosure and is in the best interest of sound tax administration.

FILING REQUIREMENTS

The law generally requires a tax-exempt political organization to file:

- an initial notice of status on Form 8871,
- periodic reports of contributions and expenditures on Form 8872,
- annual information returns on Form 990 or Form 990–EZ, and
- annual income tax returns on Form 1120–POL.

See Rev. Rul. 2000–49 (2000–2 C.B. 430), and the attachment below for more information on the basic filing requirements. Forms may be downloaded from the IRS Web site at *www.irs.gov*. The IRS Web site also describes filing requirements at *www.irs.gov/polorgs*. To obtain assistance from the IRS, please call **877–829–5500** (a toll-free call).

VOLUNTARY COMPLIANCE PROGRAM

The IRS will not assert any tax, penalty or interest that arises solely because a political organization failed to file a form or filed an incorrect form, **if** the form is filed or corrected by **July 15, 2002**. This voluntary compliance program applies with respect to the following forms:

- Any Form 8871, *Political Organization Notice of 527 Status*, due on or before July 15, 2002,
- Any Form 8872, *Report of Contributions and Expenditures*, due on or before July 15, 2002,
- Any Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations*, due on or before July 15, 2002, including any applicable extensions,
- Any Form 990, *Return of Organization Exempt from Income Tax*, or Form 990–EZ, *Short Form Return of Organization Exempt from Income Tax*, due on or before July 15, 2002, including any applicable extensions.

If a political organization does not completely report its contributions and expenditures on all applicable Forms 8872 filed by July 15, 2002, it remains liable for the amount due under § 527(j)(1) on the unreported amounts. For any form described above that is filed or corrected **after** July 15, 2002, any applicable taxes, penalties and interest will be due from the original due date. In addition, this voluntary compliance program does not apply to any Form 1120–POL required to be filed under rules in effect before July 1, 2000, so a political organization remains liable for the tax on its investment income due under § 527(b).

FILING INFORMATION

Any paper forms and correspondence filed in accordance with this notice

should contain the following information at the top of the form and on the envelope.

This is filed in accordance with Notice 2002–34.

Electronic versions of Forms 8871 and 8872 are not required to include this information.

DRAFTING INFORMATION

The principal author of this notice is Judith E. Kindell of the Exempt Organizations Rulings and Agreements Division. For further information regarding this notice, please call TE/GE Customer Service at 877–829–5500 (a toll-free call).

ATTACHMENT — POLITICAL ORGANIZATION FILING REQUIREMENTS

Tax-exempt political organizations, as defined in § 527 of the Internal Revenue Code (political organizations), must file some or all of four forms as a condition of tax-exempt status. This attachment discusses the filing requirements for political organizations without regard to the voluntary compliance program announced in this notice.

Political organizations include parties, committees, associations, funds or other entities organized and operated "primarily for the purpose of directly or indirectly accepting contributions or making expenditures." Political organizations accept contributions and make expenditures for the purpose of influencing the "selection, nomination, election, or appointment of any individual to Federal, State, or local public office or office in a political organization, or the election of Presidential electors." Political organizations include political party committees, Federal, State and local candidate committees and other political committees such as political action committees (PACs).

Who Has to File

The filing requirements in the chart below apply to those political organizations that:

- wish to be exempt from federal income tax provisions, and
- receive or expect to receive $25,000 or more in gross receipts in any taxable year

If You Are A	*You File*
Federal candidate committee, political party committee, or PAC required to report to the Federal Election Commission (FEC)	➢ Form 1120–POL; and ➢ Form 990 or Form 990–EZ
State or local candidate committee or state or local committee of a political party	➢ Form 8871; ➢ Form 1120–POL; and ➢ Form 990 or Form 990–EZ
Any other political organization, including state or local PACs and federal political organizations that are not required to report to the FEC	➢ Form 8871; ➢ Form 8872; ➢ Form 1120–POL; and ➢ Form 990 or Form 990–EZ

NOTE: You still file a Form 1120–POL if you are:

- A political organization that does not seek tax-exemption, or
- A tax-exempt political organization that does not have gross receipts of at least $25,000, but does receive in excess of $100 in taxable income in any taxable year.

Form Filing Requirements

1. Form 8871 — Notice of 527 Status

To be tax-exempt, a political organization that expects to receive $25,000 or more in gross receipts in any taxable year must file Form 8871 with the IRS, unless it is required to report as a political committee to the FEC. Form 8871, *Political Organization Notice of 527 Status*, must be filed both electronically and in writing, within 24 hours of the political organization's establishment. Until the political organization files the form, its income (including contributions) is subject to taxation and is reported on Form 1120–POL.

2. Form 8872 — Report of Contributions and Expenditures

Political organizations file Form 8872, *Political Organization Report of Contributions and Expenditures*, to disclose information concerning:

- persons receiving expenditures that aggregate $500 or more per person, per calendar year; and
- persons making contributions that aggregate $200 or more per person, per calendar year.

A political organization that does not disclose this information must pay an amount equal to the highest corporate tax rate (35 percent) multiplied by the amount of contributions and expenditures not disclosed and report this on the Form 1120–POL. If a political organization does not file Form 8871 and is subject to tax on its income, it is not required to file Form 8872.

For filing dates, see Q&A–28 through Q&A–33 of Rev. Rul. 2000–49.

3. Form 1120–POL — *U.S. Income Tax Return for Certain Political Organizations*

Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations*, is due by the 15th day of the 3rd month after the end of the organization's taxable year. Political organizations may request a six-month extension of the filing deadline by filing Form 7004, *Application for Automatic Extension of Time to File Corporate Income Tax Return*. This extension must be filed by the due date of

Form 1120–POL. There is a penalty for failure to file Form 1120–POL.

4. Form 990 or 990–EZ — *Return of Organization Exempt from Income Tax*

Exempt political organizations with gross receipts of less than $100,000 and assets of less than $250,000 at the end of the year may file a Form 990–EZ, *Short Form Return of Organization Exempt From Income Tax*. All other exempt political organizations should file a Form 990, *Return of Organization Exempt From Income Tax*.

Forms 990 or 990–EZ are due on the 15th day of the 5th month after the end of the organization's taxable year. There is a penalty for failure to file this return.

Organizations may request a three-month extension, without showing cause, by filing Form 8868, *Application for Extension of Time to File an Exempt Organization Return*, by the due date. A second three-month extension, with cause, may also be requested through Form 8868.

Form	When filed	Exceptions to filing requirement
8871	Within 24 hours of establishment	➢ Political committee required to report to the FEC; ➢ Organization that reasonably expects annual gross receipts to always be less than $25,000
8872	At organization's option, quarterly/semiannually or monthly, on same basis for entire calendar year (see form instructions for detailed information)	➢ Political committees required to report to the FEC; ➢ State and local committees of political parties; ➢ Campaign committees of state and local candidates; ➢ Organizations that reasonably expect gross receipts to always be less than $25,000
1120–POL	Due the 15th day of the 3rd month after the close of the taxable year	➢ Political organizations whose annual gross receipts are less than $25,000, and who have taxable income less than $100
990 or 990–EZ	Due the 15th day of the 5th month after the close of the taxable year	➢ Political organizations whose annual gross receipts are less than $25,000

Tax Avoidance Using Notional Principal Contracts

Notice 2002–35

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is used by taxpayers to generate tax losses. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

In general, the transaction involves the use of a notional principal contract ("NPC") to claim current deductions for periodic payments made by a taxpayer ("T") while disregarding the accrual of a right to receive offsetting payments in the future. The NPC has a term of more than one year. Under the NPC, *T* is required to make periodic payments to *CP* at regular intervals of one year or less based on a fixed or floating rate index. In return, *CP* is required to make a single payment at the end of the term of the NPC that consists of a noncontingent component and a contingent component. The noncontingent component, which is relatively large in comparison to the contingent component, may be based upon a fixed or floating interest rate. The contingent component may reflect changes in the value of a stock index or currency.

T may fund its obligation to make periodic payments in whole or in part by borrowing funds from a lender, who may be *CP*. In addition, *T* may engage in other transactions, such as interest rate collars, for purposes of limiting risk with respect to the NPC transaction. *T* may engage in short-term trading activity in securities with a view to establishing a trade or business. *T* may also engage in the transaction through a partnership, in which case instead of *T*, the partnership may engage in some or all of the activities described above. *T* will likely enter into an agreement with *CP* to terminate the NPC prior to the scheduled payment date of *CP*'s payment.

T deducts the ratable daily portion of each periodic payment for the taxable year to which that portion relates. However, *T* does not accrue income with respect to the nonperiodic payment until the year the payment is received. *T* intends to report as capital any gain it realizes upon the termination of the NPC.

ANALYSIS

The requirement of § 1.446–3(f)(2)(i) that a nonperiodic payment must be recognized over the term of a NPC in a manner that reflects the economic substance of the contract must be applied separately to the noncontingent component of the contract, whether that component is based on a fixed or a floating interest rate.

For a discussion of the proper treatment of the periodic and nonperiodic payments made pursuant to the interest rate swap if the noncontingent component is based on a fixed interest rate, *see* Rev. Rul. 2002–30 (2002–21 I.R.B. 971), May 28, 2002 (holding that the nonperiodic payment must be accrued ratably over the

term of the NPC). In addition, depending on the facts of the particular case, the Service may challenge the purported tax results of these transactions on other grounds, including by: (i) recharacterizing one or more of the transactions under §§ 1.446–3(g)(2) or 1.446–3(i); (ii) determining that the swap expense, if any, was not incurred in the course of a trade or business and was therefore subject to the 2-percent floor limitation in section 67 of the Internal Revenue Code; (iii) disregarding the combination of the loans and the periodic payments as circular flows of cash; or (iv) applying other variations of the doctrine of substance-over-form.

The Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under section 6662, the return preparer penalty under section 6694, the promoter penalty under section 6700, and the aiding and abetting penalty under section 6701.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice 2002–35 are identified as "listed transactions" for purposes of § 1.6011–4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111–2T(b)(2) of the Temporary Procedure and Administrative Regulations. *See also* § 301.6112–1T, A–4. It should be noted that, independent of their classification as "listed transactions" for purposes of §§ 1.6011–4T(b)(2) and 301.6111–2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111–2T and 301.6112–1T, A–4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111–1T and 301.6112–1T, A–3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under section 6707(a), and to the penalty under section 6708(a) if the requirements of section 6112 are not satisfied.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this Notice. These taxpayers are advised to take prompt action to file amended returns.

The principal author of this Notice is Elizabeth Handler of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this Notice, contact Ms. Handler at (202) 622–3930 (not a toll-free call).

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26 CFR 601.204: Changes in accounting periods and methods of accounting.
(Also Part I, §§ 61, 446, 451, 481, 1012; 1.61–1, 1.446–1, 1.451–1, 1.481–1, 1.1012–1.)

Rev. Proc. 2002–36

SECTION 1. PURPOSE

This revenue procedure provides taxpayers that purchase vehicles subject to leases and assume the associated leases from motor vehicle dealers with a safe harbor method of accounting for capital cost reduction payments ("CCR payments") made by vehicle lessees. This revenue procedure also provides a procedure for taxpayers to obtain automatic consent of the Commissioner to change to the safe harbor method of accounting.

SECTION 2. BACKGROUND

.01 Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided, gross income means all income from whatever source derived.

.02 Section 451(a) and § 1.451–1(a) of the Income Tax Regulations provide that the amount of any item of gross income should be included in a taxpayer's gross income for the taxable year in which actually or constructively received by the taxpayer, unless, under the taxpayer's method of accounting, such amount is properly includible for a different year.

.03 Section 1012 provides that the basis of property is the cost of the property. In general, section 1.1012–1(a) provides that the cost is the amount paid for the property in cash or other property.

.04 Under § 446(e) and § 1.446–1(e)(2)(i), a taxpayer generally must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the terms and conditions necessary to obtain consent to change a method of accounting.

.05 The Treasury Department and the Internal Revenue Service are aware that the proper tax treatment of CCR payments by purchasers of leased vehicles has become a source of significant controversy. For reasons of administrative convenience and to avoid further controversy in this area, Treasury and the Service have determined that it is appropriate to provide purchasers with a safe harbor method of accounting for CCR payments, under which a CCR payment is excluded from the purchaser's basis in the purchased vehicle (and is excluded from the purchaser's gross income). Treasury and the Service believe the scope of the safe harbor method provided in this revenue procedure is appropriate given the current vehicle lease market and lease financing market. However, Treasury and the Service may modify the scope of this safe harbor method as necessary to respond to changes in leasing market conditions.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who purchase motor vehicles subject to leases in connection with which a lessee has made a CCR payment, as defined in section 4.01 of this revenue procedure, to the dealer/lessor of the vehicle at the inception of the lease.

SECTION 4. DEFINITIONS

.01 *CCR Payment*. A CCR payment is any payment made at the inception of a motor vehicle lease by the lessee to the dealer from which the vehicle is leased that has the effect of reducing the total amount of rent the lessee will pay after inception of the lease. A CCR payment may consist of a cash down payment, the trade-in value of a lessee's used vehicle, a rebate or incentive supplied by the manufacturer to the lessee, credits earned under a credit card reward program, or the first or last monthly rental payment. A CCR payment does not include refundable security deposits; extended service plan fees; insurance premiums; title, registration, or license fees; sales, lease, excise, use, or *ad valorem* taxes paid in advance

or collected by the dealer; or administrative fees; made by a lessee in connection with a motor vehicle lease.

.02 *Taxpayer*. A "taxpayer" for purposes of this revenue procedure is a purchaser of a motor vehicle that is subject to a lease in connection with which a lessee has made a CCR payment to the dealer from which the lessee originally leased the vehicle.

SECTION 5. CCR METHOD

Under the CCR method, the amount of a CCR payment is not includible in the taxpayer's gross income and may not be included in the taxpayer's basis in the purchased vehicle.

SECTION 6. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING THE CCR METHOD

A taxpayer within the scope of this revenue procedure that is using the CCR method provided in section 5 of this revenue procedure on May 3, 2002, may continue to use this safe harbor method for taxable years ending on or after May 3, 2002, without filing a Form 3115, *Application to Change a Method of Accounting*. Such taxpayer's method of excluding CCR payments from both its gross income and its basis in the purchased vehicle will not be raised as an issue in a taxable year that ends before May 3, 2002. Moreover, if such taxpayer's method of excluding CCR payments from both its gross income and its basis in the purchased vehicle is already an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002–9 (2002–3 I.R.B. 327)) in a taxable year that ends before May 3, 2002, the issue will not be further pursued.

SECTION 7. CHANGE IN METHOD OF ACCOUNTING

.01 *Limitations, Terms, and Conditions*. A change to the CCR method provided by this revenue procedure will be treated as a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. Therefore, a taxpayer within the scope of this revenue procedure that does not use the CCR method provided in section 5 of this revenue procedure on May 3, 2002, but wants to use this safe harbor method for taxable years ending on or after December 31, 2001, must file a Form 3115.

.02 *Automatic Change to CCR Method*. A taxpayer within the scope of this revenue procedure that wants to change to the CCR method provided by section 5 of this revenue procedure must follow the automatic change in method of accounting provisions of Rev. Proc. 2002–9 (or its successor), as modified by Rev. Proc. 2002–19 (2002–13 I.R.B. 696) with the following modifications:

(1) The scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply to a taxpayer that wants to make the change for its first or second taxable year ending on or after December 31, 2001;

(2) When filing the Form 3115, taxpayers must complete all applicable parts of the form and, in lieu of the label required by section 6.02(4) of Rev. Proc. 2002–9, are instructed to write "Filed under Rev. Proc. 2002–36" at the top of the form.

.03 *Section 481(a) Adjustment*. As provided in section 2 of Rev. Proc. 2002–19, the period for negative § 481(a) adjustments is one year, and the period for positive § 481(a) adjustments is four years.

.04 *Audit Protection*. If a taxpayer complies with the requirements of this revenue procedure and changes its method of accounting for CCR payments to the CCR method provided in section 5 of this revenue procedure, the treatment of CCR payments will not be raised as an issue in any taxable year before the year of change and, if the treatment of CCR payments is already an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002–9) in a taxable year before the year of change, that issue will not be further pursued.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified and amplified to include this automatic change in section 5A of the APPENDIX.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2001.

DRAFTING INFORMATION

The principal author of this revenue procedure is Joy Ruff of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Ruff at (202) 622–5020 (not a toll-free call).

Notice of Proposed Rulemaking and Notice of Public Hearing

Notice of Significant Reduction in the Rate of Future Benefit Accrual

REG–136193–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the requirements of section 4980F of the Internal Revenue Code (Code) and section 204(h) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, which apply to defined benefit plans and to individual account plans that are subject to the funding standards of section 412 of the Code and section 302 of ERISA. These regulations provide guidance on the requirements for plan administrators to give notice of plan amendments to adversely affected plan participants and other parties when those amendments provide for a significant reduction in the rate of future benefit accrual or the elimination or significant reduction in an early retirement benefit or retirement-type subsidy. These regulations will affect retirement plan sponsors and administrators, participants in and beneficiaries of retirement plans, and employee organizations representing retirement plan participants. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 22, 2002. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for August 15, 2002, at 10 a.m., must be received by July 22, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–136193–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–136193–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, Seventh Floor, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Janet A. Laufer at (202) 622–6090 or Diane S. Bloom at (202) 283–9888; concerning submissions, Donna Poindexter at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S Washington, DC 20224. Comments on the collection of information should be received by June 24, 2002. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collections of information in this proposed regulation are in § 54.4980F–1. Responses to this collection of information are required in order to obtain a benefit. Specifically, this information is required for a taxpayer who wants to amend a plan that is subject to the requirements of section 204(h) or section 4980F to significantly reduce the rate of future benefit accrual or significantly reduce an early retirement benefit or retirement-type subsidy. This information will be used to notify participants, alternate payees, and employee organizations of the amendment.

Estimated total annual reporting burden: 40,000 hours

The estimated annual burden per respondent varies from one hour to 80 hours, depending on individual circumstances, with an estimated average of 10 hours.

Estimated number of respondents: 4,000

Estimated annual frequency of responses: Once

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 204(h) was added to ERISA by section 11006(a) of the Single-Employer Pension Plan Amendments Act of 1986, Title XI of Public Law 99–272

(100 Stat. 237) and was amended by section 1879(u)(1) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2913) (TRA '86). As amended by TRA '86, section 204(h) of ERISA (section 204(h)) required a plan administrator to provide notice to participants and other interested persons after the date of adoption and at least 15 days before the effective date of a plan amendment providing for a significant reduction in the rate of future benefit accrual.

Pursuant to section 101(a) of Reorganization Plan No. 4 of 1978, 29 U.S.C. 1001nt, the Secretary of the Treasury generally has authority to issue regulations under parts 2 and 3 of subtitle B of title I of ERISA, including section 204 of ERISA. Under section 104 of Reorganization Plan No. 4, the Secretary of Labor retains enforcement authority with respect to parts 2 and 3 of subtitle B of title I of ERISA, but, in exercising such authority, is bound by the regulations issued by the Secretary of the Treasury. On December 15, 1995, temporary regulations (T.D. 8631, 1996–1 C.B. 54), under section 411 of the Internal Revenue Code (Code), 26 U.S.C. 411, were published in the **Federal Register** (60 FR 64320), along with a notice of proposed rulemaking (EE–34–95, 1996–1 C.B. 761) cross-referencing the temporary regulations (60 FR 64401). Those temporary regulations addressed the notice requirements of section 204(h). On December 14, 1998, final regulations (T.D. 8795, 1999–1 C.B. 459) addressing the notice requirements of section 204(h) were published in the **Federal Register**. See § 1.411(d)–6.

Section 659 of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 38) (EGTRRA) added section 4980F of the Code, which imposes an excise tax when a plan administrator fails to provide timely notice of plan amendments that provide for a significant reduction in the rate of future benefit accrual, and, for this purpose, treats the elimination or reduction of an early retirement benefit or retirement-type subsidy as a reduction in the rate of future benefit accrual. EGTRRA also amended section 204(h) to treat the elimination or reduction of an early retirement benefit or retirement-type subsidy as a reduction in the rate of future benefit accrual. The requirement in section 204(h)(1) that notice be given after the date of adoption and at least 15 days in advance of the amendment's effective date was replaced by a requirement contained in both section 4980F(e)(3) and section 204(h)(3) that, except as provided in regulations, the notice be provided within a "reasonable time" before the effective date of the amendment. The notice requirements in section 4980F of the Code are essentially identical to the notice requirements in section 204(h), as amended by EGTRRA. In addition, section 204(h) has been amended by EGTRRA to provide that, in the case of an egregious failure to meet the notice requirements, the provisions of the plan are applied as if the amendment entitled applicable individuals to the greater of the benefits to which they would have been entitled without regard to the amendment or the benefits under the plan as amended.

The Job Creation and Worker Assistance Act of 2002, Public Law 107–147 (116 Stat. 21) included certain technical corrections to section 659 of EGTRRA.

These proposed regulations, when finalized, would replace the Treasury regulations currently at § 1.411(d)–6 to reflect the EGTRRA changes outlined above. Since the notice requirements of section 204(h) are now also required under section 4980F of the Code, these proposed regulations are issued under section 4980F, but apply for purposes of section 204(h), as well as for purposes of section 4980F.

Explanation of Provisions

Statutory Requirements After EGTRRA

Section 4980F(e) of the Code and section 204(h) of ERISA require notice to be provided when a defined benefit plan or a money purchase pension or other individual account plan that is subject to the funding standards of section 412 of the Code is amended to significantly reduce the rate of future benefit accrual. This notice must be provided to participants and alternate payees for whom the amendment is reasonably expected to significantly reduce the rate of future benefit accrual, and to employee organizations representing such participants. For purposes of these rules, an amendment that eliminates or reduces an early retirement benefit or retirement-type subsidy is treated as an amendment that reduces the rate of future benefit accrual. The notice must contain sufficient information (as determined in accordance with regulations) to enable such individuals to understand the effect of the amendment and, except to the extent provided in regulations, must be provided within a reasonable time before the effective date of the amendment. Additionally, section 4980F(e)(2) of the Code and section 204(h)(2) of ERISA authorize the Secretary to provide special rules for plans covering fewer than 100 participants and for plans that offer participants the option to choose between the new benefit formula and the old benefit formula.

A plan amendment that is subject to the notice requirements of section 4980F of the Code and section 204(h) of ERISA (section 204(h) amendment) may be subject to additional reporting and disclosure requirements under title I of ERISA, such as the requirement to provide a summary of material modifications (SMM) describing the amendment. Notice under section 4980F of the Code and section 204(h) of ERISA (referred to in the proposed regulations as section 204(h) notice) must be provided in accordance with the provisions of these regulations even though sections 102(a) and 104(b) of ERISA also may require that an SMM describing the plan amendment be furnished to participants covered under the plan and beneficiaries receiving benefits under the plan. The Department of Labor has advised the IRS that, at least until the effective date of final regulations under section 4980F of the Code, a plan administrator that provides a section 204(h) notice to applicable individuals in accordance with these proposed regulations will be treated as having furnished those individuals with an SMM regarding the section 204(h) amendment. The plan administrator is required to satisfy any other requirements regarding the furnishing of SMMs or updated summary plan descriptions, including, for example, satisfaction of the requirement to furnish an SMM to any other participants covered under the plan, and to beneficiaries receiving benefits under the plan, who are entitled to an SMM regarding the amendment.

Time for Providing Section 204(h) Notice Under Proposed Regulations

The proposed regulations aim to strike a balance between giving participants and other affected parties section 204(h) notice long enough in advance to enable them to understand and consider the information before the amendment goes into effect, and allowing employers the ability to effect changes to their plans for business reasons (such as to facilitate business reorganizations or to permit small businesses the flexibility to reduce costs promptly) within a reasonable time. The Treasury Department and IRS have concluded, based on the history of the legislation, that the reason why the 15-day advance notice required under section 204(h) as it existed prior to EGTRRA was replaced by the "reasonable time" standard is because the 15-day standard was perceived as often being insufficient. Accordingly, these proposed regulations would provide that a reasonable time generally means at least 45 days before the effective date of the plan amendment.

However, the proposed regulations include certain special timing rules, including rules that would allow section 204(h) notice to be provided as late as 15 days before the effective date of the amendment in two types of cases. First, the proposed regulations would generally permit section 204(h) notice to be provided 15 days in advance for amendments adopted in connection with business mergers and acquisitions. Second, the proposed regulations include a 15-day advance notice requirement with respect to amendments of small plans. Thus, the 15-day standard that was in section 204(h) before EGTRRA would generally continue to apply for small plans and for amendments adopted in connection with business mergers and acquisitions for which notice would have been required under section 204(h) as in effect before EGTRRA. The proposed regulations provide an additional special timing rule that applies in the case of an amendment that is adopted in connection with a business merger or acquisition involving a plan-to-plan transfer or merger and that affects only an early retirement benefit or retirement-type subsidy (but does not reduce the rate of future benefit accrual). In the case of such an amendment, the notice must be provided no later than 30 days after the effective date of the amendment.

In the case of a plan amendment which offers participants the option to choose between the new benefit formula and the old benefit formula, the general timing rules would apply, except that the proposed regulations would allow certain additional information to be provided at a later date, as described in *Content of Section 204(h)Notice* of this preamble.

Content of Section 204(h) Notice

Section 4980F(e)(2) of the Code and section 204(h)(2) of ERISA require section 204(h) notice to be written in a manner calculated to be understood by the average plan participant and to provide sufficient information (as determined in accordance with regulations) to allow applicable individuals to understand "the effect of" the amendment.

The Conference report for EGTRRA states that the changes to the section 204(h) of ERISA notice requirements were expected to "provide for alternative disclosures rather than a single disclosure methodology that may not fit all situations," and also notes "the need to consider the complex actuarial calculations and assumptions involved in providing necessary disclosures." H.R. Rep. 107–84, at 266. In addition, particular concern was expressed about the effects of conversion of traditional defined benefit plans to cash balance or hybrid formula plans and the effects of "wear-away" provisions under which participants earn no additional benefits for a period of time after conversion. H.R. Rep. 107–84, at 266.

The content requirements in these proposed regulations take into account this background and generally seek to ensure that adversely affected participants receive sufficient information to enable them to understand the impact and magnitude of the changes being made to their pension plan, without imposing unduly burdensome requirements on employers and while permitting latitude to employers in diverse businesses with varying employee demographics to determine how to communicate plan changes in an appropriately effective manner. Accordingly, the proposed regulations provide general standards for the content of a section 204(h) notice, rather than containing specific requirements for each type of notice.

The proposed regulations require a section 204(h) notice to include sufficient information to allow applicable individuals to understand the effect of the plan amendment, including the approximate magnitude of the expected reduction. The type and amount of information necessary to satisfy this standard varies depending on the nature of the change resulting from the amendment. The information must be written in a manner calculated to be understood by the average plan participant. The notice must describe the affected provisions prior to plan amendment, describe these provisions as amended, and state the effective date of the amendment. This description of plan provisions might be similar to the description of a plan's benefit accrual formula in a summary plan description that satisfies the requirements under § 2520.102–3 of the Department of Labor regulations. If the amendment applies by its terms differently to various classes of employees (such as where the amendment applies differently depending on what division an employee is in), the explanation must include sufficient information to allow an affected participant to understand the general class or classes of participants to whom the reduction applies. Also, these proposed regulations clarify that, in cases in which a plan amendment affects different classes of applicable individuals differently, the plan administrator may provide different section 204(h) notices. A section 204(h) notice cannot include materially false or misleading information (or omit information so as to cause the information provided to be misleading).

If a section 204(h) amendment reduces an early retirement benefit or retirement-type subsidy merely as a result of reducing the rate of future benefit accrual, the section 204(h) notice need not contain a separate description of that reduction in the early retirement benefit or retirement-type subsidy.

Additional information may be necessary to make the approximate magnitude of the reduction apparent. In cases in which it is not reasonable to expect that

the approximate magnitude of the reduction will be reasonably apparent from a narrative description, one or more illustrative examples are required to be included in the notice. Thus, for example, illustrative examples would be required for a change from a traditional defined benefit formula to a cash balance formula or a change that results in a period of time during which there are no accruals with regard to normal retirement benefits or an early retirement subsidy (a wear-away period). However, examples are not required to illustrate circumstances under which a participant's benefit may increase as a result of the section 204(h) amendment.

Where an amendment may result in reductions that vary in their impact on applicable individuals, the examples must show the approximate range of the reductions. However, the range of reductions need not include reductions that are likely to occur in only a *de minimis* number of cases if a narrative statement is included to that effect (for example, such a narrative might state that larger or smaller reductions may occur in some other cases) and examples are provided that show the approximate range of the reductions in cases other than this *de minimis* number. For amendments for which the maximum reduction occurs under identifiable circumstances with proportionately smaller reductions in other cases, the range of reductions can be illustrated by one example illustrating the maximum reduction, with a statement that smaller reductions also occur. Further, assuming that the reduction varies from small to large depending on service or other factors, as might occur for an amendment that results in a wear-away, two illustrative examples may be provided showing the smallest likely reduction and the largest likely reduction.

Examples are not required to be based on any particular form of payment (such as a life annuity or a single sum), but may be based on whatever form appropriately illustrates the reduction. The examples may be based on any reasonable assumptions, such as assumptions relating to age, service, and compensation (and salary scale assumptions for amendments that alter the compensation taken into account under the plan, such as a change from a final pay plan to a career average pay plan), but the section 204(h) notice must identify those assumptions. The proposed regulations include special rules for determining whether an amendment is reasonably expected to result in a wear-away period.

The proposed regulations include special rules for any case in which an applicable individual can choose between the new formula and the old formula. Under these rules, the individual must be provided sufficient information to enable the individual to make an informed choice between the new and old benefit formulas. The information to enable the individual to make an informed choice is not required to be provided at the same time as section 204(h) notice is otherwise required to be provided, as long as it is provided within a period that is reasonably contemporaneous with the individual's choice and that allows sufficient advance notice to enable the individual to understand and consider the additional information before making the choice.

A section 204(h) notice may include more information than is required, but cannot include any false or misleading information and cannot include so much additional information that the required information fails to be provided in a manner calculated to come to the attention of applicable individuals. While a notice for an amendment converting a traditional final pay plan to a cash balance plan must include an estimate of the future normal retirement benefit of the participant in the illustration even if that requires an estimate of future wage increases, a section 204(h) notice could also include alternative estimates. For example, an alternative estimate could be based on an assumption that there are no future wage increases.

The proposed regulations include several examples, including examples that are intended to show the illustrations that are required for a cash balance conversion amendment that is based on a very simplified form of conversion. For more complex conversion amendments, it is expected that more illustrations may be appropriate. However, these regulations do not require section 204(h) notice to include different illustrative examples to address the amount of the reduction for every demographic variation (*e.g.*, differences in compensation or years of service).

Excise Tax Under Internal Revenue Code Section 4980F(c)(1)

Section 4980F(c)(1) of the Code provides that no excise tax is imposed on a failure for any period during which it is established to the satisfaction of the Secretary that the employer (or other person responsible for the tax) did not know that the failure existed and exercised reasonable diligence to meet the notice requirements. The proposed regulations provide that the requirements of section 4980F(c)(1) of the Code are satisfied if and only if the person that would be responsible for the tax exercised reasonable diligence in attempting to deliver timely section 204(h) notice to applicable individuals (by the latest date permitted under the regulations) and believed that section 204(h) notice was actually and timely delivered to each applicable individual. An example of this illustrates that section 4980F(c)(1) of the Code would apply to a situation in which a plan administrator relies on an overnight delivery service to send materials to the persons who are expected to hand deliver section 204(h) notice to participants, and the overnight delivery service is late in making that delivery.

ERISA Provisions Regarding Egregious Failures

Section 204(h)(6)(A) of ERISA, as amended by EGTRRA, provides that in the case of an egregious failure to meet the notice requirements, the provisions of the plan are applied as if the plan amendment entitled applicable individuals to the greater of the benefits to which they would have been entitled without regard to the amendment or the benefits under the plan as amended. Section 204(h)(6)(B) of ERISA provides that, for this purpose, there is an egregious failure to meet the section 204(h) notice requirements if such failure is within the control of the plan sponsor and is an intentional failure (including any failure to promptly provide the required notice or information after the plan administrator discovers an

unintentional failure to meet notice requirements) or a failure to provide most of the individuals with most of the information they are entitled to receive. The proposed regulations provide that a failure is not egregious if the plan administrator reasonably determines, taking into account the statute, administrative guidance, and relevant facts and circumstances, that the reduction is not significant. The proposed regulations clarify that, in the case of a failure that is not egregious, the failure will not preclude the amendment from becoming effective. However, where there is a failure, whether or not egregious, recourse may be available under ERISA section 502 to, among other things, recover benefits due under the plan, enforce rights under the terms of the plan, clarify rights to future benefits under the plan, obtain equitable relief, or otherwise redress such violation. This might occur, for example, if a participant receives and thus uses materially inadequate or misleading information in making a choice between the new and the old benefit formula.

Method of Delivery of Section 204(h) Notice

As a general standard, the section 204(h) notice either must be provided through a method that results in actual receipt of the notice or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing the notice results in actual receipt. Therefore, section 204(h) notice may not be provided by "posting."

Section 4980F(g) of the Code and section 204(h)(7) of ERISA, as amended by EGTRRA, state that the Secretary of Treasury may by regulation allow 204(h) notice to be provided using new technologies. Because those provisions specifically relate to electronic delivery and were enacted after enactment of the Electronic Signatures in Global and National Commerce Act (114 Stat. 464) (2000) (E-SIGN Act), the authority conferred by those provisions on the Secretary to decide whether to permit, and under what conditions to permit, electronic delivery of section 204(h) notice is not constrained by the provisions of the E-SIGN Act.

Section 4980F(g) of the Code and section 204(h)(7) of ERISA give the Secretary of the Treasury authority to impose appropriate criteria for the provision of section 204(h) notice through electronic methods to ensure that applicable individuals will receive section 204(h) notice electronically and are able to access it timely. As noted above, section 204(h) notice either must be provided through a method that results in actual receipt of the notice or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing the notice results in actual receipt. These proposed regulations would apply the same standard to the electronic delivery of section 204(h) notice by requiring that the method used result in actual receipt or that the plan administrator take appropriate and necessary measures to ensure that any provision of the notice in electronic format results in actual receipt of the transmitted information. Additionally, the plan administrator must offer to provide each applicable individual a paper version of the notice free of charge. Of course, the requirements of these regulations must otherwise be satisfied when section 204(h) notice is provided in electronic format. The proposed regulations include a number of examples illustrating the rules applicable to the electronic provision of a section 204(h) notice and also include a safe harbor, which has conditions similar to the consumer protection provisions of section 101(c) of the E-SIGN Act.

Under the proposed regulations, permitted electronic means for furnishing section 204(h) notice would include e-mail, a site on the Internet, or other electronic communications site, and a DVD or CD that could generally be accessed using a computer at an employee's worksite. However, section 204(h) notice information is not considered provided merely because it is available through a computer kiosk, even when the kiosk is at the individual's workplace and the individual is otherwise provided notice of the availability of information at the kiosk, because, like posting, providing such information through a kiosk places a burden on participants to seek out the information. Nevertheless, information made available through a kiosk is considered provided to those applicable individuals who actually access the information through the kiosk.

Proposed Effective Date

These proposed regulations would apply to amendments that go into effect on or after the date that is 120 days after publication of final regulations in the **Federal Register**. The proposed regulations also restate the general statutory effective date and special effective date rules that are in section 659(c) of EGTRRA. Thus, the proposed regulations include the transition rule of section 659(c)(2) of EGTRRA that provides that, for amendments taking effect on or after the date of enactment of EGTRRA (June 7, 2001) and prior to the effective date of the final regulations, the notice requirements of section 4980F(e)(2) and (3) of the Code, and of section 204(h) of ERISA as amended by EGTRRA, are treated as satisfied if the plan administrator makes a reasonable, good faith effort to comply with those requirements.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

It is hereby certified that the collection of information in these proposed regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that small entities generally do not have very complex benefit structures in their plans, or many different classes of participants who will be differently affected by an amendment reducing the rate of future benefit accrual. Small entities also have fewer employees, and so those small entities that are required to provide section 204(h) notice need to provide it to fewer individuals. Accordingly, the time required for them to prepare and provide section 204(h) notice will usually be modest. Furthermore, because most small entities will only be affected when they amend the retirement plans they sponsor to reduce or eliminate benefits,

and most small entities will not so amend the retirement plans frequently, it is generally expected that most small entities would be required to provide section 204(h) notice only once over the course of several years. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and IRS specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 15, 2002, beginning at 10 a.m., in the IRS Auditorium, Seventh Floor, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the main entrance, located at 1111 Constitution Avenue, NW. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "For Further Information Contact" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written or electronic comments and an outline of the topics to be discussed and time to be devoted to each topic (preferably a signed original and eight (8) copies) by July 22, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Janet A. Laufer, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 54 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows: Authority: 26 U.S.C. 7805 * * *

§ 1.411(d)(6) [Removed]

Par. 2. Section 1.411(d)–6 is removed.

PART 54—PENSION EXCISE TAXES

Par. 3. The authority citation for part 54 is amended by adding the following citation in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
§ 54.4980F–1 is also issued under 26 U.S.C. 4980.* * *

Par. 4 Section 54.4980F–1 is added to read as follows:

§ 54.4980F–1 Notice requirements for certain pension plan amendments significantly reducing benefit accruals.

(a) *Table of contents.* This paragraph contains a list of the questions in § 54. 4980F–1(b).

Q–1. What are the notice requirements of section 4980F(e) of the Internal Revenue Code and section 204(h) of ERISA?
Q–2. What are the differences between section 4980F and section 204(h)?
Q–3. What is an "applicable pension plan" to which section 4980F of the Internal Revenue Code and section 204(h) apply?
Q–4. What is "section 204(h) notice" and what is a "section 204(h) amendment"?
Q–5. For which amendments is section 204(h) notice required?
Q–6. What is an amendment that reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy for purposes of determining whether section 204(h) notice is required?
Q–7. What plan provisions are taken into account in determining whether an amendment is a section 204(h) amendment?
Q–8. What is the basic principle used in determining whether a reduction in the rate of future benefit accrual or an early retirement benefit or retirement-type subsidy is significant for purposes of section 204(h)?
Q–9. When must section 204(h) notice be provided?
Q–10. To whom must section 204(h) notice be provided?
Q–11. What information is required to be provided in a section 204(h) notice?
Q–12. What special rules apply if participants can choose between the old and new benefit formulas?
Q–13. How may section 204(h) notice be provided?
Q–14. What are the consequences if a plan administrator fails to provide section 204(h) notice?
Q–15. What are some of the rules that apply with respect to the excise tax under section 4980F?
Q–16. How do section 4980F and section 204(h) apply when a business is sold?
Q–17. How are amendments to cease accruals and terminate a plan treated under section 4980F and section 204(h)?
Q–18. What is the effective date of section 4980F of the Internal Revenue Code, section 204(h) of ERISA, as amended by EGTRRA, and these regulations?

(b) *Questions and answers.* The questions and answers are as follows:

Q–1. What are the notice requirements of section 4980F(e) of the Internal Revenue Code and section 204(h) of ERISA?

A–1. (a) *Requirements of Internal Revenue Code section 4980F(e) and ERISA section 204(h).* Section 4980F of the Internal Revenue Code (section 4980F) and section 204(h) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), 29 U.S.C. 1054(h)

(section 204(h)) each generally requires notice of an amendment to an applicable pension plan that either provides for a significant reduction in the rate of future benefit accrual or that eliminates or significantly reduces an early retirement benefit or retirement-type subsidy. The notice is required to be provided to plan participants or alternate payees who are applicable individuals (as defined in Q&A–10 of this section) and to certain employee organizations. The plan administrator must generally provide the notice before the effective date of the plan amendment. Q&A–9 of this section sets forth the time frames for providing notice, Q&A–11 of this section sets forth the content requirements for the notice, and Q&A–12 of this section contains special rules for cases in which participants can choose between the old and new benefit formulas.

(b) *Other notice requirements*. Other provisions of law may require that certain parties be notified of a plan amendment. See, for example, sections 102 and 104 of ERISA, and the regulations thereunder, for requirements relating to summary plan descriptions and summaries of material modifications.

Q–2. What are the differences between section 4980F and section 204(h)?

A–2. Section 4980F was added to the Internal Revenue Code by the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 38) (2001) (EGTRRA). EGTRRA also amended section 204(h) to, among other things, extend the notice requirement to a plan amendment that eliminates or significantly reduces an early retirement benefit or retirement-type subsidy, even if it does not significantly reduce the rate of future benefit accrual. The notice requirements of section 4980F generally are parallel to the notice requirements of section 204(h), as amended by EGTRRA. However, the consequences of the two provisions differ: section 4980F imposes an excise tax on a failure to satisfy the notice requirements, while section 204(h)(6), as amended by EGTRRA, contains a special rule with respect to egregious failures. See Q&A–14 and Q&A–15 of this section. Except to the extent specifically indicated, these regulations apply both to section 4980F and to section 204(h).

Q–3. What is an "applicable pension plan" to which section 4980F and section 204(h) apply?

A–3. (a) *In general*. Section 4980F and section 204(h) apply to an applicable pension plan. For purposes of section 4980F, an *applicable pension plan* means a defined benefit plan qualifying under section 401(a) or 403(a) of the Internal Revenue Code, or an individual account plan that is subject to the funding standards of section 412 of the Internal Revenue Code. For purposes of section 204(h), an *applicable pension plan* means a defined benefit plan that is subject to part 2 of subtitle B of title I of ERISA, or an individual account plan that is subject to such part 2 and to the funding standards of section 412 of the Internal Revenue Code. Accordingly, individual account plans that are not subject to the funding standards of section 412 of the Internal Revenue Code, such as profit-sharing and stock bonus plans, are not applicable pension plans to which section 4980F or section 204(h) apply . Similarly, a defined benefit plan that neither qualifies under section 401(a) or 403(a) of the Internal Revenue Code nor is subject to part 2 of subtitle B of title I of ERISA is not an applicable pension plan. Further, neither a governmental plan (within the meaning of section 414(d) of the Internal Revenue Code), nor a church plan (within the meaning of section 414(e) of the Internal Revenue Code) with respect to which no election has been made under section 410(d) of the Internal Revenue Code is an applicable pension plan.

(b) *Section 204(h) notice not required for small plans covering no employees*. Section 204(h) notice is not required for a plan under which no employees are participants covered under the plan, as described in § 2510.3–3(b) of the Department of Labor regulations, and which has fewer than 100 participants.

Q–4. What is "section 204(h) notice" and what is a "section 204(h) amendment"?

A–4. *Section 204(h) notice* is notice that complies with section 4980F(e), section 204(h)(1), and this section. A *section 204(h) amendment* is an amendment for which section 204(h) notice is required under this section.

Q–5. For which amendments is section 204(h) notice required?

A–5. (a) *Significant reduction in the rate of future benefit accrual*. Section 204(h) notice is required for an amendment to an applicable pension plan that provides for a significant reduction in the rate of future benefit accrual, including a cessation of benefit accrual.

(b) *Early retirement benefits and retirement-type subsidies*. Section 204(h) notice is required for an amendment to an applicable pension plan that provides for the significant reduction of an early retirement benefit or retirement-type subsidy. For purposes of this section, *early retirement benefit* and *retirement-type subsidy* mean early retirement benefits and retirement-type subsidies within the meaning of section 411(d)(6)(B)(i).

(c) *Elimination or cessation of benefits*. For purposes of this section, the terms *reduce* or *reduction* include *eliminate* or *cease* or *elimination* or *cessation*.

(d) *Delegation of authority to Commissioner*. The Commissioner may provide in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) that section 204(h) notice need not be provided for plan amendments otherwise described in paragraph (a) or (b) of this Q&A–5 that the Commissioner determines to be necessary or appropriate, as a result of changes in the law, to maintain compliance with the requirements of the Internal Revenue Code (including requirements for tax qualification), ERISA, or other applicable federal law.

Q–6. What is an amendment that reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy for purposes of determining whether section 204(h) notice is required?

A–6. (a) *In general*. For purposes of determining whether section 204(h) notice is required, an amendment reduces the rate of future benefit accrual or reduces an early retirement benefit or retirement-type subsidy only as provided in paragraph (b) or (c) of this Q&A–6.

(b) *Reduction in rate of future benefit accrual*—(1) *Defined benefit plans*. For purposes of section 4980F and section 204(h), an amendment to a defined benefit plan reduces the rate of future benefit accrual only if it is reasonably expected to reduce the amount of the future annual benefit commencing at normal retirement

age for benefits accruing for a year. For this purpose, the annual benefit commencing at normal retirement age is the benefit payable in the form in which the terms of the plan express the accrued benefit (or, in the case of a plan in which the accrued benefit is not expressed in the form of an annual benefit commencing at normal retirement age, the benefit payable in the form of a single life annuity commencing at normal retirement age that is the actuarial equivalent of the accrued benefit expressed under the terms of the plan, as determined in accordance with section 411(c)(3) of the Internal Revenue Code).

(2) *Individual account plans.* For purposes of section 4980F and section 204(h), an amendment to an individual account plan reduces the rate of future benefit accrual only if it is reasonably expected to reduce the amounts allocated in the future to participants' accounts for a year. Changes in the investments or investment options under an individual account plan are not taken into account for this purpose.

(3) *Determination of rate of future benefit accrual.* The rate of future benefit accrual for purposes of this paragraph (b) is determined without regard to optional forms of benefit within the meaning of § 1.411(d)–4, Q&A–1(b) of this chapter (other than the annual benefit described in paragraph (b)(1) of this Q&A–6). The rate of future benefit accrual is also determined without regard to ancillary benefits and other rights or features as defined in § 1.401(a)(4)–4(e) of this chapter.

(c) *Reduction of early retirement benefits or retirement-type subsidies.* For purposes of section 4980F and section 204(h), an amendment reduces an early retirement benefit or retirement-type subsidy only if it is reasonably expected to eliminate or reduce an early retirement benefit or retirement-type subsidy.

Q–7. What plan provisions are taken into account in determining whether an amendment is a section 204(h) amendment?

A–7. (a) *Plan provisions taken into account.* All plan provisions that may affect the rate of future benefit accrual, early retirement benefits, or retirement-type subsidies of participants or alternate payees must be taken into account in determining whether an amendment is a section 204(h) amendment. For example, plan provisions that may affect the rate of future benefit accrual include the dollar amount or percentage of compensation on which benefit accruals are based; the definition of service or compensation taken into account in determining an employee's benefit accrual; the method of determining average compensation for calculating benefit accruals; the definition of normal retirement age in a defined benefit plan; the exclusion of current participants from future participation; benefit offset provisions; minimum benefit provisions; the formula for determining the amount of contributions and forfeitures allocated to participants' accounts in an individual account plan; in the case of a plan using permitted disparity under section 401(l) of the Internal Revenue Code, the amount of disparity between the excess benefit percentage or excess contribution percentage and the base benefit percentage or base contribution percentage (all as defined in section 401(l) of the Internal Revenue Code); and the actuarial assumptions used to determine contributions under a target benefit plan (as defined in § 1.401(a)(4)–8(b)(3)(i) of this chapter). Plan provisions that may affect early retirement benefits or retirement-type subsidies include the right to receive payment of benefits after severance from employment and before normal retirement age and actuarial factors used in determining optional forms for distribution of retirement benefits.

(b) *Plan provisions not taken into account.* Plan provisions that do not affect the rate of future benefit accrual of participants or alternate payees are not taken into account in determining whether there has been a reduction in the rate of future benefit accrual. Further, any benefit that is not a section 411(d)(6) protected benefit as described in § 1.411(d)–4, Q&A–1(d) of this chapter, or that is a section 411(d)(6) protected benefit that may be eliminated or reduced as permitted under § 1.411(d)–4, Q&A–2(a) or (b) of this chapter, is not taken into account in determining whether an amendment is a section 204(h) amendment. Thus, for example, provisions relating to vesting schedules or the right to make after-tax contributions or elective deferrals are not taken into account.

(c) *Example.* The following example illustrates the rules in this Q&A–7:

Example. (i) *Facts.* A defined benefit plan provides a normal retirement benefit equal to 50% of final average compensation times a fraction (not in excess of one), the numerator of which equals the number of years of participation in the plan and the denominator of which is 20. A plan amendment is adopted that changes the numerator or denominator of that fraction.

(ii) *Conclusion.* The plan amendment must be taken into account in determining whether there has been a reduction in the rate of future benefit accrual.

Q–8. What is the basic principle used in determining whether a reduction in the rate of future benefit accrual or a reduction in an early retirement benefit or retirement-type subsidy is significant for purposes of section 204(h)?

A–8. (a) *General rule.* Whether an amendment reducing the rate of future benefit accrual or reducing an early retirement benefit or retirement-type subsidy provides for a reduction that is significant for purposes of section 204(h) is determined based on reasonable expectations taking into account the relevant facts and circumstances at the time the amendment is adopted.

(b) *Application for determining significant reduction in the rate of future benefit accrual.* For a defined benefit plan, the determination of whether an amendment provides for a significant reduction in the rate of future benefit accrual is made by comparing the amount of the annual benefit commencing at normal retirement age, as determined under Q&A–6(b)(1) of this section, under the terms of the plan as amended with the amount of the annual benefit commencing at normal retirement age, as determined under Q&A–6(b)(1) of this section, under the terms of the plan prior to amendment. For an individual account plan, the determination of whether an amendment provides for a significant reduction in the rate of future benefit accrual is made in accordance with Q&A–6(b)(2) of this section by comparing the amounts to be allocated in the future to participants' accounts under the terms of the plan as amended with the amounts to be allocated in the future to participants' accounts under the terms of the plan prior to amendment.

(c) *Application to certain amendments reducing early retirement benefits or retirement-type subsidies.* Because section 204(h) notice is required only for reductions that are significant, section 204(h)

notice is not required for an amendment that reduces an early retirement benefit or retirement-type subsidy if the amendment is permitted under the third sentence of section 411(d)(6)(B) of the Internal Revenue Code and regulations thereunder (relating to the elimination or reduction of benefits or subsidies which create significant burdens or complexities for the plan and plan participants unless the amendment adversely affects the rights of any participant in a more than *de minimis* manner).

Q–9. When must section 204(h) notice be provided?

A–9. (a) *45-day general rule*. Except as described in paragraphs (b) and (c) of this Q&A–9, section 204(h) notice must be provided at least 45 days before the effective date of any section 204(h) amendment. See paragraph (d) of this Q&A–9 for special rules for amendments permitting participant choice.

(b) *15-day rule for small plans*. Except for amendments described in paragraph (c)(2) of this Q&A–9, in the case of a small plan, section 204(h) notice must be at least 15 days before the effective date of any section 204(h) amendment. For purposes of this section, a small plan is a plan that the plan administrator reasonably expects to have, on the effective date of the section 204(h) amendment, fewer than 100 participants who have an accrued benefit under the plan.

(c) *Special timing rule for business transactions*—(1) *15-day rule for section 204(h) amendment in connection with an acquisition or disposition*. Except for amendments described in paragraph (c)(2) of this Q&A–9, if a section 204(h) amendment is adopted in connection with an acquisition or disposition, section 204(h) notice must be provided at least 15 days before the effective date of the section 204(h) amendment.

(2) *Later notice permitted for section 204(h) amendment significantly reducing early retirement benefit or retirement-type subsidies in connection with certain plan transfers, mergers, or consolidations*. If a section 204(h) amendment is adopted with respect to liabilities that are transferred to another plan in connection with a transfer, merger, or consolidation of assets or liabilities as described in section 414(l) of the Internal Revenue Code and § 1.414(l)–1 of this chapter, the amendment is adopted in connection with an acquisition or disposition, and the amendment significantly reduces an early retirement benefit or retirement-type subsidy, but does not significantly reduce the rate of future benefit accrual, then section 204(h) notice must be provided no later than 30 days after the effective date of the section 204(h) amendment.

(3) *Definition of acquisition or disposition*. For purposes of this paragraph (c), see § 1.410(b)–2(f) of this chapter for the definition of acquisition or disposition.

(d) *Timing rule for amendments permitting participant choice*. In general, section 204(h) notice of a section 204(h) amendment that provides applicable individuals with a choice between the old and the new benefit formulas (as described in Q&A–12 of this section) must be provided in accordance with the time period applicable under paragraphs (a) through (c) of this Q&A–9. See Q&A–12 of this section for additional guidance regarding section 204(h) notice in connection with participant choice.

Q–10. To whom must section 204(h) notice be provided?

A–10. (a) *In general*. Section 204(h) notice must be provided to each applicable individual and to each employee organization representing participants who are applicable individuals. A special rule is provided in paragraph (d) of this Q&A–10.

(b) *Applicable individual*. Applicable individual means each participant in the plan, and any alternate payee, whose rate of future benefit accrual under the plan may reasonably be expected to be significantly reduced, or for whom an early retirement benefit or retirement-type subsidy under the plan may reasonably be expected to be significantly reduced, by the section 204(h) amendment.

(c) *Alternate payee*. Alternate payee means a beneficiary who is an alternate payee (within the meaning of section 414(p)(8) of the Internal Revenue Code) under an applicable qualified domestic relations order (within the meaning of section 414(p)(1)(A) of the Internal Revenue Code).

(d) *Designees*. Section 204(h) notice may be provided to a person designated in writing by an applicable individual or by an employee organization representing participants who are applicable individuals, instead of being provided to that applicable individual or employee organization. Any designation of a representative made through an electronic method that satisfies standards similar to those of Q&A–13(c)(1) of this section satisfies the requirement that a designation be in writing.

(e) *Facts and circumstances test*. Whether a participant or alternate payee is an applicable individual is determined based on all relevant facts and circumstances at the time the section 204(h) notice must be provided (or is provided, if earlier).

(f) *Examples*. The following examples illustrate the rules in this Q&A–10:

Example 1. (i) *Facts*. A defined benefit plan requires an individual to complete 1 year of service to become a participant who can accrue benefits, and participants cease to accrue benefits under the plan at severance from employment with the employer. There are no alternate payees and employees are not represented by an employee organization. The plan is amended effective as of January 1, 2005, to significantly reduce the rate of future benefit accrual.

(ii) *Conclusion*. Section 204(h) notice is only required to be provided to individuals who, on January 1, 2005, have completed at least 1 year of service and are employed by the employer.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that the sole effect of the plan amendment is to alter the pre-amendment plan provisions under which benefits payable to an employee who retires after 20 or more years of service are unreduced for commencement before normal retirement age. The amendment requires 30 or more years of service in order for benefits commencing before normal retirement age to be unreduced, but the amendment only applies for future benefit accruals.

(ii) *Conclusion*. Section 204(h) notice is only required to be provided to individuals who, on January 1, 2005, have completed at least 1 year of service but less than 30 years of service, are employed by the employer, have not attained normal retirement age, and will have completed 20 or more years of service before normal retirement age if their employment continues to normal retirement age.

Example 3. (i) *Facts*. A plan is amended to reduce significantly the rate of future benefit accrual for all current employees who are participants. Based on the facts and circumstances, it is reasonable to expect that the amendment will not reduce the rate of future benefit accrual of former employees who are currently receiving benefits or of former employees who are entitled to deferred vested benefits.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to any former employees.

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that the plan covers two groups of alternate payees. The alternate payees in the first group are entitled to a certain percentage or portion of the former spouse's accrued benefit and,

for this purpose, the accrued benefit is determined at the time the former spouse begins receiving retirement benefits under the plan. The alternate payees in the second group are entitled to a certain percentage or portion of the former spouse's accrued benefit and, for this purpose, the accrued benefit was determined at the time the qualified domestic relations order was issued by the court.

(ii) *Conclusion*. It is reasonable to expect that the benefits to be received by the second group of alternate payees will not be affected by any reduction in a former spouse's rate of future benefit accrual. Accordingly, the plan administrator is not required to provide section 204(h) notice to the alternate payees in the second group.

Example 5. (i) *Facts*. A plan covers hourly employees and salaried employees. The plan provides the same rate of benefit accrual for both groups. The employer amends the plan to reduce significantly the rate of future benefit accrual of the salaried employees only. At that time, it is reasonable to expect that only a small percentage of hourly employees will become salaried in the future.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to the participants who are currently hourly employees.

Example 6. (i) *Facts*. A plan covers employees in Division M and employees in Division N. The plan provides the same rate of benefit accrual for both groups. The employer amends the plan to reduce significantly the rate of future benefit accrual of employees in Division M. At that time, it is reasonable to expect that in the future only a small percentage of employees in Division N will be transferred to Division M.

(ii) *Conclusion*. The plan administrator is not required to provide section 204(h) notice to the participants who are employees in Division N.

Example 7. (i) *Facts*. The facts are the same facts as in *Example 6*, except that at the time the amendment is adopted, it is expected that thereafter Division N will be merged into Division M in connection with a corporate reorganization (and the employees in Division N will become subject to the plan's amended benefit formula applicable to the employees in Division M).

(ii) *Conclusion*. In this case, the plan administrator must provide section 204(h) notice to the participants who are employees in Division M and to the participants who are employees in Division N.

Q–11. What information is required to be provided in section 204(h) notice?

A–11. (a) *Explanation of amendment* —(1) *In general*. Section 204(h) notice must include sufficient information to allow applicable individuals to understand the effect of the plan amendment, including the approximate magnitude of the expected reduction. To the extent any expected reduction is not uniformly applicable to all participants, the notice must either identify the general classes of participants to whom the reduction is expected to apply, or by some other method include sufficient information to allow each applicable individual receiving the notice to determine which reductions are expected to apply to that individual. The information must be written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice. The type and amount of information necessary to satisfy these standards will vary depending on the nature of the change resulting from the amendment, as described further in paragraphs (a)(2) and (3) of this Q&A–11.

(2) *Required narrative*—(i) *Reduction in rate of future benefit accrual*. In the case of an amendment reducing the rate of future benefit accrual, the notice must include a description of the benefit or allocation formula prior to the amendment, a description of the benefit or allocation formula under the plan as amended, and the effective date of the amendment.

(ii) *Reduction in early retirement benefit or retirement-type subsidy*. In the case of an amendment that reduces an early retirement benefit or retirement-type subsidy (other than as a result of an amendment reducing the rate of future benefit accrual), the notice must describe how the early retirement benefit or retirement-type subsidy is calculated from the accrued benefit before the amendment, how the early retirement benefit or retirement-type subsidy is calculated from the accrued benefit after the amendment, and the effective date of the amendment. For example, if, for a plan with a normal retirement age of 65, the change is from an unreduced normal retirement benefit at age 55 to an unreduced normal retirement benefit at age 60 for benefits accrued in the future, with an actuarial reduction to apply for benefits accrued in the future to the extent that the early retirement benefit begins before age 60, the notice must state that and specify the factors that apply in calculating the actuarial reduction (*e.g.*, a 5% per year reduction applies for early retirement before age 60).

(3) *Additional required information*—(i) *Standard for additional information*. In cases in which it is not reasonable to expect that the approximate magnitude of the reduction will be reasonably apparent from the description provided in accordance with in paragraph (a)(2) of this Q&A–11, further information is required. This requirement can be satisfied by furnishing additional narrative information, as described in paragraph (a)(3)(ii) of this Q&A–11; by furnishing illustrative examples, as described in paragraph (a)(3)(iii) of this Q&A–11; or through a combination of these.

(ii) *Additional narrative information*. Further narrative explanation of the effect of the difference between the old and new formulas or benefit calculation may be provided to make the approximate magnitude of the reduction apparent.

(iii) *Illustrative examples*—(A) *Requirement generally*. In cases in which it is not reasonable to expect that the approximate magnitude of the reduction will be reasonably apparent from the description provided in accordance with in paragraph (a)(2) of this Q&A–11 (plus any additional narrative information provided in accordance with paragraph (a)(3)(ii) of this Q&A–11), the notice must include one or more illustrative examples showing the approximate magnitude of the reduction in the example. Thus, illustrative examples are required for a change from a traditional defined benefit formula to a cash balance formula or a change that results in a period of time during which there are no accruals (or minimal accruals) with regard to normal retirement benefits or an early retirement subsidy (a wear-away period).

(B) *Examples must bound the range of reductions*. Where an amendment results in reductions that vary (as would occur for an amendment converting a traditional defined benefit formula to a cash balance formula or an amendment that results in a wear-away period), the illustrative example(s) provided in accordance with this paragraph (a)(3)(iii) must show the approximate range of the reductions. However, any reductions that are likely to occur in only a *de minimis* number of cases are not required to be taken into account in determining the range of the reductions if a narrative statement is included to that effect and examples are provided that show the approximate range of the reductions in other cases. Amendments for which the maximum reduction occurs under identifiable circumstances, with proportionately smaller reductions in other cases, may be illustrated by one example illustrating the maximum reduction, with a statement that smaller reductions also occur. Further, assuming that

the reduction varies from small to large depending on service or other factors, two illustrative examples may be provided showing the smallest likely reduction and the largest likely reduction.

(C) *Assumptions used in examples.* The examples required under this paragraph (a)(3)(iii) are not required to be based on any particular form of payment (such as a life annuity or a single sum), but may be based on whatever form appropriately illustrates the reduction. The examples generally may be based on any reasonable assumptions (*e.g.*, assumptions relating to the representative participant's age, years of service, and compensation, along with any interest rate and mortality table used in the illustrations, as well as salary scale assumptions used in the illustrations for amendments that alter the compensation taken into account under the plan), but the section 204(h) notice must identify those assumptions. However, if a plan's benefit provisions include a factor that varies over time (such as a variable interest rate), the determination of whether an amendment is reasonably expected to result in a wear-away period must be based on the value of the factor applicable under the plan at a time that is reasonably close to the date section 204(h) notice is provided, and any wear-away period that is solely a result of a future change in the variable factor may be disregarded. For example, to determine whether a wear-away occurs as a result of a section 204(h) amendment that converts a defined benefit plan to a cash balance pension plan that will credit interest based on a variable interest factor specified in the plan, the future interest credits must be projected based on the interest rate applicable under the variable factor at the time section 204(h) notice is provided.

(4) *No false or misleading information.* A notice that includes materially false or misleading information (or omits information so as to cause the information provided to be misleading) does not constitute section 204(h) notice.

(b) *Additional information when reduction not uniform*—(1) *In general.* If an amendment by its terms affects different classes of participants differently (*e.g.*, one new benefit formula will apply to Division A and another to Division B), then the requirements of paragraph (a) of this Q&A–11 apply separately with respect to each such general class of participants. In addition, the notice must include sufficient information to enable an applicable individual who is a participant to understand which class he or she is a member of.

(2) *Option for different section 204(h) notices.* If a section 204(h) amendment affects different classes of applicable individuals differently, the plan administrator may provide to differently affected classes of applicable individuals a section 204(h) notice appropriate to those individuals. Such section 204(h) notice may omit information that does not apply to the applicable individuals to whom it is furnished, but must identify the class or classes of applicable individuals to whom it is provided.

(c) *Examples.* The following examples illustrate the requirements of paragraph (a) of this Q&A–11. In each example it is assumed that the notice is written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice.

Example 1. (i) *Facts.* Plan A provides that a participant is entitled to a normal retirement benefit of 2% of the participant's average pay over the 3 consecutive years for which the average is the highest (highest average pay) multiplied by years of service. Plan A is amended to provide that, effective January 1, 2004, the normal retirement benefit will be 2% of the participant's highest average pay multiplied by years of service before the effective date, plus 1% of the participant's highest average pay multiplied by years of service after the effective date. The plan administrator provides notice that states: "Under the Plan's current benefit formula, a participant's normal retirement benefit is 2% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by the participant's years of service. This formula is being changed by a plan amendment. Under the Plan as amended, a participant's normal retirement benefit will be the sum of 2% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by years of service before the effective date, plus 1% of the participant's average pay over the 3 consecutive years for which the average is the highest multiplied by the participant's years of service after the effective date. This change is effective on January 1, 2004." The notice does not contain any additional information.

(ii) *Conclusion.* The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 2. (i) *Facts.* Plan B provides that a participant is entitled to a normal retirement benefit at age 64 of 2.2% of the participant's career average pay times years of service. Plan B is amended to cease all accruals, effective January 1, 2004. The plan administrator provides notice that includes a description of the old benefit formula, a statement that after December 31, 2003, no participant will earn any further accruals, and the effective date of the amendment.

(ii) *Conclusion.* The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 3. (i) *Facts.* Plan C provides that a participant is entitled to a normal retirement benefit at age 65 of 2% of career average compensation times years of service. Plan C is amended to provide that the normal retirement benefit will be 1% of average pay over the 3 consecutive years for which the average is the highest times years of service. The amendment only applies to accruals for years of service after the amendment, so that each employee's accrued benefit is equal to the sum of the benefit accrued as of the effective date of the amendment plus the accrued benefit equal to the new formula applied to years of service beginning on or after the effective date. The plan administrator provides notice that describes the old and new benefit formulas and also explains that for an individual whose compensation increases over the individual's career such that the individual's highest 3-year average exceeds the individual's career average, the reduction will be less or there may be no reduction.

(ii) *Conclusion.* The notice satisfies the requirements of paragraph (a) of this Q&A–11.

Example 4. (i) *Facts.* (A) Plan D is a defined benefit pension plan under which each participant accrues a normal retirement benefit, as a life annuity beginning at the normal retirement age of 65, equal to the participant's number of years of service times 1.5 percent times the participant's average pay over the 3 consecutive years for which the average is the highest. Plan D provides early retirement benefits for former employees beginning at or after age 55 in the form of an early retirement annuity that is actuarially equivalent to the normal retirement benefit, with the reduction for early commencement based on reasonable actuarial assumptions that are specified in Plan D. Plan D provides for the suspension of benefits of participants who continue in employment beyond normal retirement age, in accordance with section 203(a)(3)(B) of ERISA and regulations thereunder issued by the Department of Labor. The pension of a participant who retires after age 65 is calculated under the same normal retirement benefit formula, but is based on the participant's service credit and highest 3-year pay at the time of late retirement with any appropriate actuarial increases.

(B) Plan D is amended, effective July 1, 2005, to change the formula for all future accruals to a cash balance formula under which the opening account balance for each participant on July 1, 2005, is zero, hypothetical pay credits equal to 5 percent of pay are credited to the account thereafter, and hypothetical interest is credited monthly based on the applicable interest rate under section 417(e)(3) of the Internal Revenue Code at the beginning of the quarter. Any participant who terminates employment with vested benefits can receive an actuarially equivalent annuity (based on the same reasonable actuarial assumptions that are specified in Plan D) commencing at any time after termination of employment and before the plan's normal retirement age of 65. The benefit resulting from the hypothetical account balance is in addition to the benefit accrued on June 30, 2005 (taking into account only

service and highest 3-year pay before July 30, 2005), so that it is reasonably expected that no wear-away period will result from the amendment. The plan administrator expects that, as a general rule, depending on future pay increases and future interest rates, the rate of future benefit accrual after the conversion is higher for participants who accrue benefits before approximately age 50 and after approximately age 70, but is lower for participants who accrue benefits between approximately age 50 and age 70.

(C) The plan administrator of Plan D announces the conversion to a cash balance formula on May 16, 2005. The announcement is delivered to all participants and includes a written notice that describes the old formula, the new formula, and the effective date.

(D) In addition, the notice states that the Plan D formula before the conversion provided a normal retirement benefit equal to the product of a participant's number of years of service times 1.5 percent times the participant's average pay over the 3 years for which the average is the highest (highest 3-year pay). The notice includes an example showing the normal retirement benefit that will be accrued after June 30, 2005, for a participant who is age 49 with 10 years of service at the time of the conversion. The plan administrator believes that such a participant is representative of the participants whose rate of future benefit accrual will be reduced as a result of the amendment. The example estimates that, if the participant continues employment to age 65, the participant's normal retirement benefit for service from age 49 to age 65 will be $657 per month for life. The example assumes that the participant's pay is $50,000 at age 49. The example states that the estimated $657 monthly pension accrues over the 16-year period from age 49 to age 65 and that, based on assumed future pay increases, this amount annually would be 9.1 percent of the participant's highest 3-year pay at age 65, which over the 16 years from age 49 to age 65 averages 0.57 percent per year times the participant's highest 3-year pay. The example also states that the sum of the monthly annuity accrued before the conversion in the 10-year period from age 39 to age 49 plus the $657 monthly annuity estimated to be accrued over the 16-year period from age 49 to age 65 is $1,235 and that, based on assumed future increases in pay, this would be 17.1 percent of the participant's highest 3-year pay at age 65, which over the employee's career from age 39 to age 65 averages 0.66 percent per year times the participant's highest 3-year pay. The notice also includes two other examples with similar information, one of which is intended to show the circumstances in which a small reduction may occur and the other of which shows the largest reduction that the plan administrator thinks is likely to occur. The notice states that the estimates are based on the assumption that pay increases annually after June 30, 2005, at a 4 percent rate. The notice also specifies that the applicable interest rate under section 417(e) for hypothetical interest credits after June 30, 2005, is assumed to be 6 percent, which is the section 417(e) of the Internal Revenue Code applicable interest rate under the plan for 2005.

(ii) *Conclusion*. The information in the notice, as described in paragraph (i)(C) of this *Example 4*, satisfies the requirements of paragraph (a)(2) of this Q&A–11 with respect to applicable individuals who are participants. The additional requirements of paragraph (a)(3) of this Q&A–11 are satisfied because, as noted in paragraph (i)(D) of this *Example 4*, the notice describes the old formula and describes the estimated future accruals under the new formula in terms that can be readily compared to the old formula, *i.e.*, the notice states that the estimated $657 monthly pension accrued over the 16-year period from age 49 to age 65 averages 0.57 percent of the participant's highest 3-year pay at age 65. The requirement that the examples include sufficient information to be able to determine the approximate magnitude of the reduction would also be satisfied if the notice instead directly stated the amount of the monthly pension that would have accrued over the 16-year period from age 49 to age 65 under the old formula.

Example 5. (i) *Facts*. The facts are the same as in *Example 4*, except that, under the plan as in effect before the amendment, the early retirement pension for a participant who terminates employment after age 55 with at least 20 years of service is equal to the normal retirement benefit without reduction from age 65 to age 62 and reduced by only 5 percent per year for each year before age 62. As a result, early retirement benefits for such a participant constitute a retirement-type subsidy. The plan as in effect after the amendment provides an early retirement benefit equal to the sum of the early retirement benefit payable under the plan as in effect before the amendment taking into account only service and highest 3-year pay before July 1, 2005, plus an early retirement annuity that is actuarially equivalent to the account balance for service after June 30, 2005. The notice provided by the plan administrator describes the old early retirement annuity, the new early retirement annuity, and the effective date. The notice includes an estimate of the early retirement annuity payable to the illustrated participant for service after the conversion if the participant were to retire at age 59 (which the plan administrator believes is a typical early retirement age) and elect to begin receiving an immediate early retirement annuity. The example states that the normal retirement benefit expected to be payable at age 65 as a result of service from age 49 to age 59 is $434 per month for life beginning at age 65 and that the early retirement annuity expected to be payable as a result of service from age 49 to age 59 is $270 per month for life beginning at age 59. The example states that the monthly early retirement annuity of $270 is 38 percent less than the monthly normal retirement benefit of $434, whereas a 15 percent reduction would have applied under the plan as in effect before the amendment. The notice also includes similar information for examples that show the smallest and largest reduction that the plan administrator thinks is likely to occur in the early retirement benefit. The notice also specifies the applicable interest rate, mortality table, and salary scale used in the example to calculate the early retirement reductions.

(ii) *Conclusion*. The information in the notice, as described in paragraphs (i)(C) and (i)(D) of *Example 4* and paragraph (i) of this *Example 5*, satisfies the requirements of paragraph (a) of this Q&A–11 with respect to applicable individuals who are participants. The requirements of paragraph (a)(3) of this Q&A–11 are satisfied because, as noted in paragraph (i) of this *Example 5*, the notice describes the early retirement subsidy under the old formula and describes the estimated early retirement pension under the new formula in terms that can be readily compared to the old formula, *i.e.*, the notice states that the monthly early retirement pension of $270 is 38 percent less than the monthly normal retirement benefit of $434, whereas a 15 percent reduction would have applied under the plan as in effect before the amendment. The requirements of paragraph (a)(1) of this Q&A–11 would also be satisfied if the notice instead directly stated the amount of the monthly early retirement pension that would be payable at age 59 under the old formula.

Q–12. What special rules apply if participants can choose between the old and new benefit formulas?

A–12. In any case in which an applicable individual can choose between the benefit formula (including any early retirement benefit or retirement-type subsidy) in effect before the section 204(h) amendment (old formula) or the benefit formula in effect after the section 204(h) amendment (new formula), section 204(h) notice has not been provided unless the applicable individual has been provided the information required under Q&A–11 of this section, and has also been provided sufficient information to enable the individual to make an informed choice between the old and new benefit formulas. The information required under Q&A–11 of this section must be provided by the date otherwise required under Q&A–9 of this section. The information sufficient to enable the individual to make an informed choice must be provided within a period that is reasonably contemporaneous with the date by which the individual is required to make his or her choice and that allows sufficient advance notice to enable the individual to understand and consider the additional information before making that choice.

Q–13. How may section 204(h) notice be provided?

A–13. (a) A plan administrator (including a person acting on behalf of the plan administrator, such as the employer or plan trustee) must provide section 204(h) notice through a method that results in actual receipt of the notice or the plan administrator must take appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice. Section 204(h) notice must be provided either in the form of a paper document or in an electronic form that satisfies the requirements of paragraph (c) of this Q&A–13. First class

mail to the last known address of the party is an acceptable delivery method. Likewise, hand delivery is acceptable. However, the posting of notice is not considered provision of section 204(h) notice. Section 204(h) notice may be enclosed with or combined with other notice provided by the employer or plan administrator (for example, a notice of intent to terminate under title IV of ERISA). Except as provided in paragraph (c) of this Q&A–13, a section 204(h) notice is deemed to have been provided on a date if it has been provided by the end of that day. When notice is delivered by first class mail, the notice is considered provided as of the date of the United States postmark stamped on the cover in which the document is mailed.

(b) *Example.* The following example illustrates the provisions of paragraph (a) of this Q&A–13:

Example. (i) *Facts.* Plan A is amended to reduce significantly the rate of future benefit accrual effective January 1, 2005. Under Q&A–9 of this section, section 204(h) notice is required to be provided at least 45 days before the effective date of the amendment. The plan administrator causes section 204(h) notice to be mailed to all affected participants. The mailing is postmarked November 16, 2004.

(ii) *Conclusion.* Because section 204(h) notice is given 45 days before the effective date of the plan amendment, it satisfies the timing requirement of Q&A–9 of this section.

(c) *New technologies*—(1) *General rule.* A section 204(h) notice may be provided to an applicable individual through an electronic method (other than an oral communication or a recording of an oral communication), provided that all of the following requirements are satisfied:

(i) Either the notice is actually received by the applicable individual or the plan administrator takes appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice by the applicable individual.

(ii) The plan administrator provides the applicable individual with a clear and conspicuous statement, in electronic or non-electronic form, that the applicable individual has a right to request and obtain a paper version of the section 204(h) notice without charge and, if such request is made, the applicable individual is furnished with the paper version without charge.

(iii) The requirements of this section must otherwise be satisfied. Thus, for example, a section 204(h) notice provided through an electronic method must be delivered on or before the date required under Q&A–9 of this section and must satisfy the requirements set forth in Q&A–11 of this section, including the content requirements and the requirements that it be written in a manner calculated to be understood by the average plan participant and to apprise the applicable individual of the significance of the notice. Accordingly, when it is not otherwise reasonably evident, the recipient should be apprised (either in electronic or non-electronic form), at the time the notice is furnished electronically, of the significance of the notice.

(2) *Examples.* The following examples illustrate the requirement in paragraph (c)(1)(i) of this Q&A–13. In these examples, it is assumed that the notice satisfies the requirements in paragraph (c)(1)(ii) and (iii) of this section. The examples are as follows:

Example 1. (i) *Facts.* On July 1, 2003, M, a plan administrator of Company N's plan, sends notice intended to satisfy section 204(h) of ERISA to A, an employee of Company N and a participant in the plan. The notice is sent through e-mail to A's e-mail address on Company N's electronic information system. Accessing Company N's electronic information system is not an integral part of A's duties. M sends the e-mail with a request for a computer-generated notification that the message was received and opened. M receives notification indicating that the e-mail was received and opened by A on July 9, 2003.

(ii) *Conclusion.* With respect to A, although M has failed to take appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice, M satisfies the requirement of paragraph (c)(1)(i) of this Q&A–13 on July 9, 2003, which is when A actually receives the notice.

Example 2. (i) *Facts.* On August 1, 2003, O, a plan administrator of Company P's plan, sends a notice intended to satisfy section 204(h) of ERISA to B, who is an employee of Company P and a participant in Company P's plan. The notice is sent through e-mail to B's e-mail address on Company P's electronic information system. B has the ability to effectively access electronic documents from B's e-mail address on Company P's electronic information system and accessing the system is an integral part of B's duties.

(ii) *Conclusion.* Because access to the system is an integral part of B's duties, O has taken appropriate and necessary measures reasonably calculated to ensure that the method for providing section 204(h) notice results in actual receipt of the notice. Thus, regardless of whether B actually accesses B's email on that date, O satisfies the requirement of paragraph (c)(1)(i) of this Q&A–13 on August 1, 2003, with respect to B.

(3) *Safe harbor in case of consent.* The requirement of paragraph (c)(1)(i) of this Q&A–13 is deemed to be satisfied with respect to an applicable individual if the section 204(h) notice is provided electronically to an applicable individual, and—

(i) The applicable individual has affirmatively consented electronically, or confirmed consent electronically, in a manner that reasonably demonstrates the applicable individual's ability to access the information in the electronic form in which the notice will be provided, to receiving section 204(h) notice electronically and has not withdrawn such consent;

(ii) The applicable individual has provided, if applicable, in electronic or non-electronic form, an address for the receipt of electronically furnished documents;

(iii) Prior to consenting, the applicable individual has been provided, in electronic or non-electronic form, a clear and conspicuous statement indicating—

(A) That the consent can be withdrawn at any time without charge;

(B) The procedures for withdrawing consent and for updating the address or other information needed to contact the applicable individual;

(C) Any hardware and software requirements for accessing and retaining the documents; and

(D) The information required by paragraph (c)(1)(ii) of this Q&A–13; and

(iv) After consenting, if a change in hardware or software requirements needed to access or retain electronic records creates a material risk that the applicable individual will be unable to access or retain the section 204(h) notice—

(A) The applicable individual is provided with a statement of the revised hardware and software requirements for access to and retention of the section 204(h) notice and is given the right to withdraw consent without the imposition of any fees for such withdrawal and without the imposition of any condition or consequence that was not disclosed at the time of the initial consent; and

(B) The requirement of paragraph (c)(3)(i) of this Q&A–13 is again complied with.

Q–14. What are the consequences if a plan administrator fails to provide section 204(h) notice?

A–14. (a) *Egregious failures*—(1) *Effect of egregious failure to provide section 204(h) notice.* Section 204(h)(6)(A) of ERISA provides that, in the case of any egregious failure to meet the notice requirements with respect to any plan amendment, the plan provisions are applied so that all applicable individuals are entitled to the greater of the benefit to which they would have been entitled without regard to the amendment, or the benefit under the plan with regard to the amendment. For a special rule applicable

in the case of a plan termination, see Q&A–17(b) of this section.

(2) *Definition of egregious failure*. For purposes of section 204(h) of ERISA and this Q&A–14, there is an egregious failure to meet the notice requirements if a failure to provide required notice is within the control of the plan sponsor and is either an intentional failure or a failure, whether or not intentional, to provide most of the individuals with most of the information they are entitled to receive. For this purpose, an intentional failure includes any failure to promptly provide the required notice or information after the plan administrator discovers an unintentional failure to meet the requirements. A failure to give section 204(h) notice is deemed not to be egregious if the plan administrator reasonably determines, taking into account section 204(h) of ERISA, section 4980F of the Internal Revenue Code, these regulations, other administrative pronouncements, and relevant facts and circumstances, that the reduction in the rate of future benefit accrual resulting from an amendment is not significant (as described in Q&A–8 of this section), or that an amendment does not significantly reduce an early retirement benefit or retirement-type subsidy.

(3) *Example*. The following example illustrates the provisions of this paragraph (a):

Example. (i) *Facts*. Plan A is amended to reduce significantly the rate of future benefit accrual effective January 1, 2003. Section 204(h) notice is required to be provided 45 days before January 1, 2003. Timely section 204(h) notice is provided to all applicable individuals (and to each employee organization representing participants who are applicable individuals), except that the employer intentionally fails to provide section 204(h) notice to certain participants until May 16, 2003.

(ii) *Conclusion*. The failure to provide section 204(h) notice is egregious. Accordingly, for the period from January 1, 2003, through June 30, 2003 (which is the date that is 45 days after May 16, 2003), all participants and alternate payees are entitled to the greater of the benefit to which they would have been entitled under Plan A as in effect before the amendment or the benefit under the plan as amended.

(b) *Effect of non-egregious failure to provide section 204(h) notice*. If an egregious failure has not occurred, the amendment with respect to which section 204(h) notice is required may become effective with respect to all applicable individuals. However, see section 502 of ERISA for civil enforcement remedies. Thus, where there is a failure, whether or not egregious, to provide section 204(h) notice in accordance with this section, individuals may have recourse under section 502 of ERISA.

(c) *Excise taxes*. See section 4980F of the Internal Revenue Code and Q&A–15 of this section for excise taxes that may apply to a failure to notify applicable individuals of a pension plan amendment that provides for a significant reduction in the rate of future benefit accrual or eliminates or significantly reduces an early retirement benefit or retirement-type subsidy, regardless of whether or not the failure is egregious.

Q–15. What are some of the rules that apply with respect to the excise tax under section 4980F?

A–15. (a) *Person responsible for excise tax*. In the case of a plan other than a multiemployer plan, the employer is responsible for reporting and paying the excise tax. In the case of a multiemployer plan, the plan is responsible for reporting and paying the excise tax.

(b) *Excise tax inapplicable in certain cases*. Under section 4980F(c)(1) of the Internal Revenue Code, no excise tax is imposed on a failure for any period during which it is established to the satisfaction of the Commissioner that the employer (or other person responsible for the tax) exercised reasonable diligence, but did not know that the failure existed. Under section 4980F(c)(2) of the Internal Revenue Code, no excise tax applies to a failure to provide section 204(h) notice if the employer (or other person responsible for the tax) exercised reasonable diligence and corrects the failure within 30 days after the employer (or other person responsible for the tax) first knew, or exercising reasonable diligence would have known, that such failure existed. For purposes of section 4980F(c)(1) of the Internal Revenue Code, a person has exercised reasonable diligence, but did not know that the failure existed if and only if—

(1) The person exercised reasonable diligence in attempting to deliver section 204(h) notice to applicable individuals by the latest date permitted under this section; and

(2) At the latest date permitted for delivery of section 204(h) notice, the person reasonably believes that section 204(h) notice was actually delivered to each applicable individual by that date.

(c) *Example*. The following example illustrates the provisions of paragraph (b) of this Q&A–15:

Example. (i) *Facts*. Plan A is amended to reduce significantly the rate of future benefit accrual. The employer sends out a section 204(h) notice to all affected participants and other applicable individuals and to any employee organization representing applicable individuals, including actual delivery by hand to employees at worksites. However, although the employer exercises reasonable diligence in seeking to deliver the notice, the notice is not delivered to any participants at one worksite due to a failure of an overnight delivery service to provide the notice to appropriate personnel at that site for them to timely hand deliver the notice to affected employees. The error is discovered when the employer subsequently calls to confirm delivery. Appropriate section 204(h) notice is then promptly delivered to all affected participants at the worksite.

(ii) *Conclusion*. Because the employer exercised reasonable diligence, but did not know that a failure existed, no excise tax applies, assuming that participants at the worksite receive section 204(h) notice within 30 days after the employer first knew, or exercising reasonable diligence would have known, that the failure occurred.

Q–16. How do section 4980F and section 204(h) apply when a business is sold?

A–16. (a) *Generally*. Whether section 204(h) notice is required in connection with the sale of a business depends on whether a plan amendment is adopted that significantly reduces the rate of future benefit accrual or significantly reduces an early retirement benefit or retirement-type subsidy.

(b) *Examples*. The following examples illustrate the rules of this Q&A–16:

Example 1. (i) *Facts*. Corporation Q maintains Plan A, a defined benefit plan that covers all employees of Corporation Q, including employees in its Division M. Plan A provides that participating employees cease to accrue benefits when they cease to be employees of Corporation Q. On January 1, 2006, Corporation Q sells all of the assets of Division M to Corporation R. Corporation R maintains Plan B, which covers all of the employees of Corporation R. Under the sale agreement, employees of Division M become employees of Corporation R on the date of the sale (and cease to be employees of Corporation Q), Corporation Q continues to maintain Plan A following the sale, and the employees of Division M become participants in Plan B.

(ii) *Conclusion*. No section 204(h) notice is required because no plan amendment was adopted that reduced the rate of future benefit accrual. The employees of Division M who become employees of Corporation R ceased to accrue benefits under Plan A because their employment with Corporation Q terminated.

Example 2. (i) *Facts*. Subsidiary Y is a wholly owned subsidiary of Corporation S. Subsidiary Y

maintains Plan C, a defined benefit plan that covers employees of Subsidiary Y. Corporation S sells all of the stock of Subsidiary Y to Corporation T. At the effective date of the sale of the stock of Subsidiary Y, in accordance with the sale agreement between Corporation S and Corporation T, Subsidiary Y amends Plan C so that all benefit accruals cease.

(ii) *Conclusion*. Section 204(h) notice is required to be provided because Subsidiary Y adopted a plan amendment that significantly reduced the rate of future benefit accrual in Plan C.

Example 3. (i) *Facts*. As a result of an acquisition, Corporation U maintains two plans: Plan D covers employees of Division N and Plan E covers the rest of the employees of Corporation U. Plan E provides a significantly lower rate of future benefit accrual than Plan D. Plan D is merged with Plan E, and all of the employees of Corporation U will accrue benefits under the merged plan in accordance with the benefit formula of former Plan E.

(ii) *Conclusion*. Section 204(h) notice is required.

Example 4.— (i) *Facts*. The facts are the same as in *Example 3*, except that the rate of future benefit accrual in Plan E is not significantly lower. In addition, Plan D has a retirement-type subsidy that Plan E does not have and the Plan D employees' rights to the subsidy under the merged plan are limited to benefits accrued before the merger.

(ii) *Conclusion*. Section 204(h) notice is required for any participants or beneficiaries for whom the reduction in the retirement-type subsidy is significant (and for any employee organization representing such participants).

Example 5. (i) *Facts*. Corporation V maintains several plans, including Plan F, which covers employees of Division P. Plan F provides that participating employees cease to accrue further benefits under the plan when they cease to be employees of Corporation V. Corporation V sells all of the assets of Division P to Corporation W, which maintains Plan G for its employees. Plan G provides a significantly lower rate of future benefit accrual than Plan F. Plan F is merged with Plan G as part of the sale, and employees of Division P who become employees of Corporation W will accrue benefits under the merged plan in accordance with the benefit formula of former Plan G.

(ii) *Conclusion*. No section 204(h) notice is required because no plan amendment was adopted that reduces the rate of future benefit accrual or eliminates or significantly reduces an early retirement benefit or retirement-type subsidy. Under the terms of Plan F as in effect prior to the merger, employees of Division P cease to accrue any further benefits (including benefits with respect to early retirement benefits and any retirement-type subsidy) under Plan F after the date of the sale because their employment with Corporation V terminated.

Q–17. How are amendments to cease accruals and terminate a plan treated under section 4980F of the Internal Revenue Code and section 204(h) of ERISA?

A–17. (a) *General rule*—(1) *Rule*. An amendment providing for the cessation of benefit accruals on a specified future date and for the termination of a plan is subject to section 4980F of the Internal Revenue Code and section 204(h) of ERISA.

(2) *Example*. The following example illustrates the rule of paragraph (a)(1) of this Q&A–17:

Example. (i) *Facts*. An employer adopts an amendment that provides for the cessation of benefit accruals under a defined benefit plan on December 31, 2003, and for the termination of the plan pursuant to title IV of ERISA as of a proposed termination date that is also December 31, 2003. As part of the notice of intent to terminate required under title IV in order to terminate the plan, the plan administrator gives section 204(h) notice of the amendment ceasing accruals, which states that benefit accruals will cease "on December 31, 2003." However, because all the requirements of title IV for a plan termination are not satisfied, the plan cannot be terminated until a date that is later than December 31, 2003.

(ii) *Conclusion*. Nonetheless, because section 204(h) notice was given stating that the plan was amended to cease accruals on December 31, 2003, section 204(h) does not prevent the amendment to cease accruals from being effective on December 31, 2003. The result would be the same had the section 204(h) notice informed the participants that the plan was amended to provide for a proposed termination date of December 31, 2003, and to provide that "benefit accruals will cease on the proposed termination date whether or not the plan is terminated on that date." However, neither section 4980F of the Internal Revenue Code nor section 204(h) of ERISA would be satisfied with respect to the December 31, 2003, effective date if the section 204(h) notice had merely stated that benefit accruals would cease "on the termination date" or "on the proposed termination date."

(3) *Additional requirements under title IV of ERISA*. See 29 CFR 4041.23(b)(4) and 4041.43(b)(5) for special rules applicable to plans terminating under title IV of ERISA.

(b) *Terminations in accordance with title IV of ERISA*. A plan that is terminated in accordance with title IV of ERISA is deemed to have satisfied section 4980F of the Internal Revenue Code and section 204(h) of ERISA not later than the termination date (or date of termination, as applicable) established under section 4048 of ERISA. Accordingly, neither section 4980F of the Internal Revenue Code nor section 204(h) of ERISA would in any event require that any additional benefits accrue after the effective date of the termination.

(c) *Amendment effective before termination date of a plan subject to title IV of ERISA*. To the extent that an amendment providing for a significant reduction in the rate of future benefit accrual or a significant reduction in an early retirement benefit or retirement-type subsidy has an effective date that is earlier than the termination date (or date of termination, as applicable) established under section 4048 of ERISA, that amendment is subject to section 4980F of the Internal Revenue Code and section 204(h) of ERISA. Accordingly, the plan administrator must provide section 204(h) notice (either separately, with, or as part of the notice of intent to terminate) with respect to such an amendment.

Q–18. What is the effective date of section 4980F of the Internal Revenue Code, section 204(h) of ERISA, as amended by EGTRRA, and these regulations?

A–18. (a) *Statutory effective date*—(1) *General rule*. Section 4980F of the Internal Revenue Code and section 204(h) of ERISA, as amended by EGTRRA, apply to plan amendments taking effect on or after June 7, 2001 (statutory effective date), which is the date of enactment of EGTRRA.

(2) *Transition rule*. For amendments applying after the statutory effective date in paragraph (a)(1) of this Q&A–18 and prior to the regulatory effective date in paragraph (c) of this Q&A–18, the requirements of section 4980F(e)(2) and (3) of the Internal Revenue Code and section 204(h) of ERISA, as amended by EGTRRA, are treated as satisfied if the plan administrator makes a reasonable, good faith effort to comply with those requirements.

(3) *Special notice rule*—(i) *In general*. Notwithstanding Q&A–9 of this section, section 204(h) notice is not required by section 4980F(e) of the Internal Revenue Code or section 204(h) of ERISA, as amended by EGTRRA, to be provided prior to September 7, 2001 (the date that is three months after the date of enactment of EGTRRA).

(ii) *Reasonable notice*. The requirements of section 4980F of the Internal Revenue Code and section 204(h) of ERISA, as amended by EGTRRA, do not apply to any plan amendment that takes effect on or after June 7, 2001, if, before April 25, 2001, notice was provided to participants and beneficiaries adversely affected by the plan amendment (and their representatives) which was reasonably expected to notify them of the nature and effective date of the plan amendment. For purposes of this paragraph (a)(3)(ii),

notice that complies with § 1.411(d)–6 of this chapter, as it appeared in the April 1, 2001, edition of 26 CFR part 1, is deemed to be notice which was reasonably expected to notify participants and beneficiaries adversely affected by the plan amendment (and their representatives) of the nature and effective date of the plan amendment.

(b) *Amendments taking effect prior to June 7, 2001.* For rules applicable to amendments taking effect prior to June 7, 2001, see § 1.411(d)–6 of this chapter, as it appeared in the April 1, 2001, edition of 26 CFR part 1.

(c) *Regulatory effective date.* Q&A–1 through Q&A–18 of this section apply to amendments taking effect on or after the date that is 120 days after publication of final regulations under this section (regulatory effective date).

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 22, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 23, 2002, 67 F.R. 19713)

Partial Withdrawal of Previous Proposed Rules; Notice of Proposed Rulemaking and Notice of Public Hearing

Information Reporting for Qualified Tuition and Related Expenses; Magnetic Media Filing Requirements for Information Returns

REG–161424–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of previous proposed rules; notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document withdraws in part proposed regulations relating to the information reporting requirements under section 6050S. This document also contains new proposed regulations relating to the information reporting requirements under section 6050S for qualified tuition and related expenses. These proposed regulations reflect changes to the law made by the Taxpayer Relief Act of 1997 and the amendments made by the Internal Revenue Service Restructuring and Reform Act of 1998 and Public Law 107–131. The regulations provide guidance to eligible educational institutions that enroll any individual for any academic period. The regulations also provide guidance to insurers that make reimbursements or refunds of qualified tuition and related expenses. This document provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by July 29, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for August 13, 2002, at 10 a.m. must be received by July 23, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–161424–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–161424–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Taxpayers may also submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at *www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Donna Welch, (202) 622–4910; concerning submissions of comments, the hearing and/or to be placed on the building access list to attend the hearing, Donna Poindexter, (202) 622–7180, and concerning the magnetic media filing specifications, waivers for filing on magnetic media, and extensions of time, contact the Internal Revenue Service, Martinsburg Computing Center, (304) 263–8700 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1678.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

1. *Summary*

This document withdraws § 1.6050S–1 of the notice of proposed rulemaking (REG–105316–98, 2000–2 C.B. 98) relating to the information reporting requirements under section 6050S that was published in the **Federal Register** (65 FR 37728) on June 16, 2000 (the 2000 proposed regulations). This document also contains new proposed amendments to 26 CFR part 1 in § 1.6050S–1 relating to information reporting requirements under section 6050S for eligible educational institutions and insurers (these proposed regulations). The IRS and the Treasury Department have determined that the 2000 proposed regulations addressing the information reporting requirements for payees who receive payments of interest on qualified education loans will be finalized in a separate Treasury decision.

2. *Effective Date of These Proposed Regulations and Reporting Requirements for the Calendar Year 2002*

The information reporting requirements in these proposed regulations are proposed to apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2003, for amounts reportable for the calendar year 2003 and subsequent years. These proposed regulations will not be effective until they are finalized. Therefore, the information reporting requirements in Notice 97–73 (1997–2

C.B. 335), as modified, continue for information returns required to be filed, and information statements required to be furnished, for amounts reportable for the calendar year 2002 (for which the returns and statements are required to be filed and furnished in 2003). However, taxpayers may rely on these proposed regulations for guidance pending issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

3. *Current Statutory Provisions*

The Taxpayer Relief Act of 1997 (Public Law 105–34 (111 Stat. 788) (TRA ’97)) added section 25A of the Internal Revenue Code (Code) to provide the Hope Scholarship Credit and the Lifetime Learning Credit (education tax credit). In general, the education tax credit allows certain taxpayers who pay qualified tuition and related expenses (qualified expenses) to an eligible educational institution (an institution) to claim a nonrefundable credit against their Federal income tax liability. On January 6, 1999, the IRS issued proposed regulations under section 25A. See 64 FR 794 (1999).

In addition, TRA ’97 added section 6050S of the Code. Section 6050S was amended by the Internal Revenue Service Restructuring and Reform Act of 1998 (Public Law 105–206 (112 Stat. 685) (RRA ’98)). In general, section 6050S requires eligible educational institutions who receive payments of qualified tuition and related expenses to file information returns and to furnish written information statements to assist taxpayers and the IRS in determining any education tax credit allowable under section 25A (as well as other tax benefits for higher education expenses). See H.R. Conf. Rept. No. 599, 105th Cong., 2d Sess., pp. 319–320 (1998).

In addition, section 6050S requires any person engaged in a trade or business of making payments to any individual under an insurance agreement as reimbursements or refunds of qualified tuition and related expenses (an insurer) to file information returns and to furnish written information statements. Lastly, section 6050S requires certain payees who receive payments of interest on one or more qualified education loans to file information returns and to furnish written information statements to assist taxpayers and the IRS in determining any interest deduction allowable under section 221.

As currently in effect, section 6050S(b) provides that the information return filed by an eligible educational institution or insurer must contain: (1) the name, address, and taxpayer identification number (TIN) of the individual with respect to whom payments were received, or the reimbursements or refunds were made, of qualified tuition and related expenses; (2) the name, address, and TIN of any individual certified by the individual as the taxpayer who will claim that individual as a dependent for purposes of the deduction allowable under section 151 for any taxable year ending with or within the year for which the information return is filed; (3) the aggregate amount of payments of qualified tuition and related expenses received by the eligible educational institution during the calendar year with respect to the individual; (4) the aggregate amount of reimbursements or refunds of qualified tuition and related expenses paid by an institution or an insurer during the calendar year with respect to the individual; (5) the aggregate amount of any scholarships or grants that the eligible educational institution processed during the calendar year for the individual’s costs of attendance; and (6) such other information as the Secretary may prescribe.

4. *Previous Guidance Under Section 6050S*

The IRS has published several notices prescribing limited information reporting for eligible educational institutions for the years 1998, 1999, 2000, and 2001. See Notice 97–73 (1997–2 C.B. 335), Notice 98–46 (1998–2 C.B. 290), Notice 98–59 (1998–49 I.R.B. 16), Notice 99–37 (1999–2 C.B. 124), and Notice 2000–62 (2000–2 C.B. 587).

A notice of proposed rulemaking under section 6050S (REG–105316–98) was published in the **Federal Register** (65 FR 37728) on June 16, 2000. A public hearing was held on the proposed regulations on February 13, 2001. The IRS received written and electronic comments responding to the 2000 notice of proposed rulemaking.

5. *Recent Amendments to Section 6050S*

Section 6050S was further amended by Public Law 107–131 (115 Stat. 2410), effective for qualified expenses paid or billed after December 31, 2002, for academic periods beginning after December 31, 2002. For calendar years beginning after December 31, 2002, eligible educational institutions may elect to report either the aggregate amount of payments received, or the aggregate amount billed, for qualified tuition and related expenses during the calendar year with respect to individuals enrolled for any academic period. Institutions will no longer be required to report separately any refunds or reimbursements of qualified expenses made during the calendar year that relate to payments received for qualified expenses during the current calendar year. Rather, institutions will be required to report separately only adjustments made during the calendar year to payments received, or amounts billed, for qualified expenses that were reported in a prior calendar year. Institutions will be required to report scholarships or grants received for the individual’s costs of attendance that the institution administered and processed during the calendar year. In addition, institutions will be required to report separately adjustments made during the calendar year to scholarships that were reported in a prior calendar year. Section 6050S will no longer require institutions to report the name, address, and TIN of any individual certified by the individual as the taxpayer who will claim that individual as a dependent for purposes of the deduction allowable under section 151 for any taxable year ending with or within the year for which the information return is filed.

These proposed regulations reflect the amendments to section 6050S by Public Law 107–131 and address many of the concerns raised by the educational community in their comments to the 2000 proposed regulations. These proposed regulations for eligible educational institutions and insurers are discussed below.

Explanation of Provisions

1. *Information Reporting Relating to Qualified Tuition and Related Expenses*

A. *Required reporting and exceptions to reporting*

Consistent with the amendments to section 6050S by Public Law 107–131, these proposed regulations require an eligible educational institution (as defined in section 25A(f)(2) and the regulations thereunder) (an institution) to file a Form 1098–T, *Tuition Payment Statement*, with respect to each individual who is or has been enrolled for any academic period (as defined in the regulations under section 25A) and for whom reportable transactions are made during the calendar year. In addition, these proposed regulations require any person engaged in a trade or business of making payments under an insurance arrangement as reimbursements or refunds (or other similar amounts) of qualified tuition and related expenses (as defined in section 25A(f)(1) and the regulations thereunder) (an insurer) to file a Form 1098–T with the IRS with respect to each individual for whom it makes reimbursements or refunds of qualified expenses.

(i) Reporting Based on Academic Year vs. Calendar Year

The commentators to the 2000 proposed regulations requested that an institution be allowed to report financial data based on an academic year, and not based on a calendar year. Section 6050S requires institutions to report on a calendar year in order to assist taxpayers in calculating the education tax credit that is allowable for qualified expenses paid during a calendar year. Therefore, these proposed regulations do not adopt this recommendation.

(ii) Eligible Educational Institution for Portion of Calendar Year

The commentators to the 2000 proposed regulations requested clarification of the rules for determining which institutions are required to report under section 6050S and the exceptions to reporting. One commentator asked whether an institution that is not an *eligible educational institution* within the meaning of section 25A(f)(2) at the beginning of the calendar year, but becomes an eligible educational institution during the calendar year, is required to report under section 6050S, and, if so, whether the institution must report for the entire calendar year or only the portion of the year in which it is an eligible educational institution. An institution that is an eligible educational institution for any portion of a calendar year must report under section 6050S. Further, because the education tax credit is allowable only for payments made to an eligible educational institution, the institution must report for only the portion of the year in which it is an eligible educational institution.

(iii) Exception for Nonresident Aliens

Several commentators to the 2000 proposed regulations requested clarification of the exception to reporting for an individual who is a nonresident alien. The 2000 proposed regulations provide that an institution or insurer must report for the year that the institution or insurer receives a request from a nonresident alien individual to report and all subsequent years. The commentators recommended that reporting be limited to the calendar year for which the institution or insurer receives the request. The commentators explained that institutions would need to create a new database to report automatically for subsequent years. These proposed regulations provide that any reporting for a nonresident alien individual is limited to the calendar year for which the institution or insurer receives a request.

(iv) Exception for Noncredit Courses

Several commentators to the 2000 proposed regulations requested clarification of the exception to reporting for an individual who is enrolled during the calendar year only in noncredit courses. The commentators noted that the exception is intended to cover students enrolled in courses for which no academic credit is offered, not students who do not receive academic credit in a particular course. Therefore, these proposed regulations clarify that the exception applies to students enrolled only in courses for which academic credit is not offered. In addition, several commentators suggested that the word "only" should be removed and that the exception should apply to students who are enrolled both in courses for which no academic credit is offered and in courses offered for credit that may lead toward a postsecondary degree. The exception is intended to cover nondegree students enrolled in courses for which no academic credit is offered, consistent with the legislative history to section 6050S. See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess., p. 322 (1998). Therefore, these proposed regulations do not adopt this recommendation.

Several commentators to the 2000 proposed regulations recommended that institutions should have discretion to define what constitutes *academic credit*. The 2000 proposed regulations define academic credit as credit awarded by an institution for the completion of coursework leading toward a postsecondary degree, certificate, or other recognized postsecondary educational credential. This definition provides a uniform test to determine academic credit for information reporting purposes. These proposed regulations retain the definition of academic credit and do not adopt this recommendation.

(v) No Exception for Small Institutions or Small Amounts of Qualified Tuition and Related Expenses

One commentator to the 2000 proposed regulations suggested that the regulations should provide an exception to reporting for institutions with 500 or fewer students, and another commentator suggested that the regulations should provide an exception for qualified expenses of $250 or less. The limited exceptions to required reporting are based on the fact that certain categories of students may not be eligible to claim the education tax credit (*e.g.*, nondegree students enrolled in noncredit courses cannot claim the Hope Scholarship Credit and nonresident alien students are generally not eligible to claim the education tax credit). See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess., p. 322 (1998). Exceptions to reporting for small institutions or small amounts of qualified expenses have no relationship to a student's eligibility to claim the education tax credit. Therefore,

these proposed regulations do not adopt these recommendations.

(vi) Exception for Students Whose Qualified Expenses Are Paid with Scholarships

Several commentators to the 2000 proposed regulations suggested that the regulations should include an exception to reporting for students whose qualified expenses are waived in their entirety or are paid entirely with scholarships. Notice 97–73 provides that institutions are not required to report for such students because the institutions will not have received any payment of qualified expenses on behalf of such students for which the student could, in general, claim the education tax credit. These proposed regulations follow the rule in Notice 97–73 and provide that an institution is not required to report on students whose qualified expenses for the calendar year are waived in their entirety or are paid entirely with scholarships.

(vii) Exception for Students Whose Qualified Expenses Are Covered by Formal Billing Arrangement between Institution and Student's Employer

Several commentators to the 2000 proposed regulations suggested that the regulations should provide an exception to reporting for students whose qualified expenses are paid by a third party (such as an employer) to the institution through a formal billing arrangement. The commentators explained that often an employer and an institution enter into an agreement in which employees attend the institution, and the institution bills only the employer. In this situation, the institution does not maintain a separate account for each employee/student. These arrangements often constitute employer-provided educational assistance excludable from the employee's gross income under section 127. Under section 25A and the regulations thereunder, taxpayers cannot claim the education tax credit for education expenses paid by an employer which are tax-free to the employee. Therefore, these proposed regulations provide an exception to reporting with respect to any individual whose qualified expenses are covered by a formal billing arrangement between an institution and the individual's employer.

(viii) Family Educational Rights and Privacy Act and Optional Reporting

Several commentators to the 2000 proposed regulations requested clarification as to whether an institution that chooses to report on students otherwise covered by an exception to required reporting would violate the Family Educational Rights and Privacy Act (FERPA) (20 U.S.C. section 1232g). The Department of Education has previously determined that reporting under section 6050S does not violate FERPA. We have asked the Department of Education to consider whether this determination extends to institutions that choose to report on students otherwise covered by an exception to required reporting in these proposed regulations.

B. *Required information for institutions*

(i) Reporting of Payments Received vs. Amounts Billed

Based on the provisions of section 6050S prior to the amendments by Public Law 107–131, the 2000 proposed regulations provide that an institution must report the aggregate amount of payments received for qualified expenses, and the aggregate amount of reimbursements or refunds made of qualified expenses, with respect to any individual during the calendar year. Numerous commentators explained that their institutions cannot report payments for, and reimbursements or refunds of, qualified expenses, because their financial systems do not apply payments and reimbursements or refunds to specific charges. According to these institutions, a student's account is a running balance of undesignated payments and reimbursements or refunds. These commentators suggested that the regulations should allow institutions that are unable to report payments received for, and reimbursements or refunds made of, qualified expenses, to report instead: (1) the amount billed with respect to any individual for qualified expenses during the calendar year; and (2) the amount of any reductions to the amounts billed with respect to the individual.

Consistent with section 6050S as amended by Public Law 107–131, these proposed regulations provide that institutions may elect to report either the payments received, or the amounts billed, during the calendar year for qualified tuition and related expenses with respect to individuals enrolled for an academic period beginning during the calendar year or during a prior calendar year.

(ii) Reporting Adjustments to Payments Received (or Amounts Billed) for a Prior Calendar Year

The commentators to the 2000 proposed regulations suggested that the regulations should distinguish between reimbursements or refunds that relate to payments received during the current calendar year and those that relate to payments for prior calendar years. The commentators suggested that, rather than reporting separately aggregate payments and aggregate reimbursements or refunds, institutions should be permitted to net current year payments of qualified expenses against any refunds of such current year payments, and to report only the net payments received for qualified expenses during the current calendar year. These commentators suggested that institutions should be required to report separately only the amount of any reimbursements or refunds made in the current year that relate to qualified expenses paid that were reported in a prior calendar year.

Consistent with this approach, the commentators also suggested that institutions reporting amounts billed should be permitted to net amounts billed for qualified expenses for the current year against any reductions in amounts billed for qualified expenses for the current year, and to report only the net amount billed for qualified expenses during the current calendar year. Similarly, the commentators suggested that these institutions should be required to report separately only those reductions made in the current year that relate to amounts billed for qualified expenses that were reported in a prior calendar year.

Congress adopted this approach in the amendments to section 6050S by Public Law 107–131. As amended, section 6050S will require institutions to report separately only adjustments made during the calendar year to payments received,

or amounts billed, that relate to amounts that were reported for a prior calendar year. For example, for institutions that report based on payments received, separate reporting will be required only for refunds or reimbursements of qualified expenses made during the calendar year that relate to payments of qualified expenses that were reported for a prior calendar year. For institutions that report based on amounts billed, separate reporting will be required only for reductions in charges made during the calendar year that relate to amounts billed for qualified expenses that were reported for a prior calendar year.

Therefore, for institutions that report based on payments received, these proposed regulations provide that, in determining the amounts to be reported under section 6050S for a calendar year, payments received for qualified expenses during the calendar year must be netted against any reimbursements or refunds of qualified expenses made during the calendar year that relate to payments received for qualified expenses during the same calendar year. These regulations also provide that reimbursements or refunds made during the calendar year that relate to payments of qualified expenses that were reported for a prior calendar year must be reported separately.

Similarly, for institutions that report based on amounts billed, these proposed regulations provide that, in determining the amounts to be reported under section 6050S for a calendar year, the amount billed for qualified expenses during the calendar year must be netted against any reductions in charges for qualified expenses made during the calendar year that relate to amounts billed for qualified expenses during the same calendar year. These regulations also provide that any reductions in charges made during the calendar year that relate to amounts reported as billed for a prior calendar year must be reported separately.

These regulations are proposed to apply to payments received, and amounts billed, for qualified expenses beginning in 2003. Therefore, the first year for which institutions may be required to collect information regarding any reimbursements or refunds of prior year reportable payments (or any reductions in reportable amounts billed for a prior year) is 2004. The amount of any reimbursements or refunds (or reductions) made in 2004 for amounts paid (or billed) in 2003 would be reported on the 2004 Forms 1098–T filed in early 2005.

(iii) Reporting Adjustments to Scholarships for a Prior Calendar Year

Consistent with section 6050S as amended by Public Law 107–131, these proposed regulations provide that all institutions must report separately any reductions in the amount of scholarships or grant aid reported for a prior calendar year.

(iv) Name, Address, and TIN of Taxpayer

The 2000 proposed regulations reserve the requirement in section 6050S(b)(2)(B) that an institution or insurer obtain and report the name, address, and TIN of any taxpayer who will claim the individual as a dependent for purposes of the deduction allowable under section 151 for the taxable year. This statutory requirement will be eliminated by the amendments to section 6050S by Public Law 107–131. Therefore, consistent with section 6050S as amended, these proposed regulations remove this requirement.

(v) Half-time Indicator

Several commentators to the 2000 proposed regulations suggested that institutions should not be required to indicate whether a student was enrolled at least half time. Another commentator suggested that institutions should be required to provide the half-time indicator only for students enrolled in undergraduate studies. An indication as to whether a student was enrolled at least half time for one academic period is useful information for the IRS to verify whether the student may be eligible to claim the Hope Scholarship Credit and certain other education tax benefits, and this information is readily available to institutions. Therefore, these proposed regulations do not adopt these recommendations.

(vi) Information Statement

The 2000 proposed regulations provide that an institution or insurer must furnish an information statement to each individual for whom it is required to file a Form 1098–T. The statement must include specific instructions to the taxpayer. These proposed regulations provide that the instructions must state that a taxpayer may claim an education tax credit only for amounts actually paid during the calendar year. These proposed regulations also provide that the instructions must state that the amount of any refunds or reimbursements of payments received, or reductions in charges, for qualified expenses or any reductions in grant aid reported for a prior calendar year may affect the amount of any education tax credit allowable for the prior calendar year.

The 2000 proposed regulations provide that the statement must include the name, address, and phone number of the individual who is the information contact for the institution or insurer that filed the Form 1098–T. Several commentators to the 2000 proposed regulations requested that the regulations should not require the name of an individual. The commentators explained that it is not feasible for institutions to provide an individual as the information contact and requested that institutions be allowed to provide an office or department of the institution as the information contact. These proposed regulations adopt this recommendation.

The 2000 proposed regulations reserve the requirement in section 6050S(d) that an institution or insurer furnish a statement to any taxpayer who will claim the individual as a dependent for purposes of the deduction allowable under section 151 for the taxable year. This statutory requirement will be eliminated by the amendments to section 6050S by Public Law 107–131. Therefore, consistent with section 6050S as amended, these regulations remove this requirement.

C. *Required information for insurers*

The information reporting requirements for insurers is not changed by the amendments to section 6050S by Public Law 107–131. Therefore, these proposed regulations continue to provide that an insurer must file an information return for each individual with respect to whom reimbursements or refunds of qualified tuition and related expenses are made during the calendar year. An insurer must include: (1) the name, address, and TIN

of the insurer; (2) the name, address, and TIN of the individual with respect to whom reimbursements or refunds of qualified tuition and related expenses were made; and (3) the aggregate amount of reimbursements or refunds of qualified tuition and related expenses that the insurer made with respect to the individual during the calendar year.

D. *Information reporting penalties*

(i) Penalty Notification

These proposed regulations, as well as the 2000 proposed regulations, provide that an institution or insurer may be subject to a penalty under section 6721 for failure to file correct Forms 1098–T and a penalty under section 6722 for failure to furnish correct information statements. The 2000 proposed regulations provide that an institution or insurer must notify the individual that the IRS may impose a $50 penalty for failure to provide a TIN. Several commentators to the 2000 proposed regulations requested that the penalty notification be removed. Section 6723 and the regulations thereunder authorize the IRS to impose a $50 penalty if an individual fails to provide his or her TIN as required but do not require an institution or insurer to give prior notification of the penalty. Therefore, these proposed regulations adopt this recommendation.

(ii) Annual TIN Solicitation Requirement

Several commentators to the 2000 proposed regulations recommended that institutions not be required to request an individual's TIN annually if the institution does not have the individual's TIN. These proposed regulations continue to provide that, in order to establish a waiver of the information reporting penalties for reasonable cause, an institution or insurer must request an individual's TIN annually if it does not have the TIN. The annual solicitation rule in these regulations is consistent with the general solicitation requirements in section 301.6724–1(e) and (f) that a filer must meet in order to establish reasonable cause. These proposed regulations clarify that a separate solicitation is not necessary if an institution requests an individual's TIN through admission or enrollment forms or financial aid applications.

(iii) Filing Information Returns with Missing TINs

Several commentators to the 2000 proposed regulations requested that institutions not be required to file information returns and to furnish information statements for individuals who refuse to provide their TINs. Information returns and information statements with missing TINs are useful to both the IRS and the individual in verifying the amount of any allowable education tax credit (as well as other tax benefits for higher education expenses). Therefore, these proposed regulations do not adopt this recommendation.

2. *Requirement to File Information Returns on Magnetic Media*

These regulations propose to amend the regulations under section 6011(e) to require institutions and insurers who are required to file 250 or more Forms 1098–T to file on magnetic media.

Special Analyses

It has been determined that these proposed regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. An initial regulatory flexibility analysis has been prepared for this notice of proposed rulemaking under section 5 U.S.C. 603 and is set forth under the heading "Initial Regulatory Flexibility Analysis" in this preamble. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Initial Regulatory Flexibility Analysis

The collection of information contained in § 1.6050S–1 is needed to assist the IRS and taxpayers in determining the amount of any education tax credit allowable under section 25A. The objectives of these regulations are to provide uniform, practicable, and administrable rules under section 6050S. The types of small entities to which the regulations may apply are small eligible educational institutions (such as colleges and universities) and certain insurers who reimburse educational expenses. As of the end of 2001, a total of 19,817,563 Forms 1098–T were filed with the IRS for 2000. The estimated reporting burden for 2001 is 9 minutes per Form 1098–T. No special professional skills are necessary for preparation of the reports or records. There are no known Federal rules that duplicate, overlap, or conflict with these proposed regulations. The regulations proposed are considered to have the least economic impact on small entities of all alternatives considered.

Moreover, the proposed regulations requiring filing Forms 1098–T on magnetic media impose no additional reporting or recordkeeping and only prescribe the method of filing information returns that are already required to be filed. Further, these regulations are consistent with the statutory requirement that an institution or insurer is not required to file Forms 1098–T on magnetic media unless required to file at least 250 or more returns during the year. Finally, the economic impact caused by requiring Forms 1098–T on magnetic media should be minimal because most institution's or insurer's operations are computerized. Even if their operations are not computerized, the incremental cost of magnetic media reporting should be minimal in most cases because of the availability of computer service bureaus. In addition, the existing regulations under section 6011(e) provide that the IRS may waive the magnetic media filing requirements on a showing of hardship. The waiver authority will be exercised so as not to unduly burden institutions and insurers lacking both the necessary data processing facilities and access at a reasonable cost to computer service bureaus.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the

proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 13, 2002, beginning at 10 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by July 23, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of the regulations is Donna Welch, Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

PART 1—INCOME TAX

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.6050S–1 also issued under section 26 U.S.C. 6050S(g). * * *

Par. 2. Sections 1.6050S–0 is amended by revising the introductory language and adding new entries for § 1.6050S–1 to read as follows:

§ 1.6050S–0 Table of contents

This section lists captions contained in §§ 1.6050S–1, 1.6050S–2T, 1.6050S–3, and 1.6050S–4T.

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(f) Effective date.

* * * * *

Par. 3. Section 1.6050S–1 is added to read as follows:

§ 1.6050S–1 Information reporting for qualified tuition and related expenses.

(a) *Information reporting requirement*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, any eligible educational institution (as defined in section 25A(f)(2) and the regulations thereunder) (an institution) that enrolls (as determined under paragraph (d)(1) of this section) any individual for any academic period (as defined in the regulations under section 25A), and any person that is engaged in a trade or business of making payments under an insurance arrangement as reimbursements or refunds (or other similar amounts) of qualified tuition and related expenses (as defined in section 25A(f)(1) and the regulations thereunder) (an insurer) must—

(i) File an information return, as described in paragraph (b) of this section, with the Internal Revenue Service (IRS) with respect to each individual described in paragraph (b) of this section; and

(ii) Furnish a statement, as described in paragraph (c) of this section, to each individual described in paragraph (c) of this section.

(2) *Exceptions*—(i) *No reporting by institution or insurer for nonresident alien individuals.* The information reporting requirements of this section do not apply with respect to any individual who is a nonresident alien (as defined in section 7701(b) and § 301.7701(b)–3 of this chapter) during the calendar year, unless the individual requests the institution or insurer to report. If a nonresident alien individual requests an institution or insurer to report, the institution or insurer must comply with the requirements of this section for the calendar year with respect to which the request is made.

(ii) *No reporting by institutions for individuals enrolled only in noncredit courses*—(A) *In general.* The information reporting requirements of this section do not apply with respect to any individual who is enrolled during the calendar year only in courses for which no academic credit is offered by the institution.

(B) *Academic credit defined. Academic credit* means credit offered by an institution for the completion of coursework leading toward a post-secondary degree, certificate, or other recognized post-secondary educational credential.

(C) *Example.* The following example illustrates the rules of this paragraph (a)(2)(ii):

Example. Student A, a medical doctor, takes a course at University X's medical school. Student A takes the course to fulfill State Y's licensing requirement that medical doctors attend continuing medical education courses each year. Student A is not enrolled in a degree program at University X and takes the medical course through University X's continuing professional education division. University X does not offer Student A credit toward a post-secondary degree on an academic transcript for the completion of the course but gives Student A a certificate of attendance upon completion. Under this paragraph (a)(2)(ii), University X is not subject to the information reporting requirements of section 6050S and this section for the medical education course taken by Student A.

(iii) *No reporting by institutions for individuals whose qualified tuition and related expenses are waived or are paid with scholarships.* The information reporting requirements of this section do not apply with respect to any individual whose qualified tuition and related expenses are waived in their entirety or are paid entirely with scholarships.

(iv) *No reporting by institutions for individuals whose qualified tuition and related expenses are covered by a formal billing arrangement*—(A) *In general.* The information reporting requirements of this section do not apply with respect to any individual whose qualified tuition and related expenses are covered by a formal billing arrangement between an institution and the individual's employer.

(B) *Formal billing arrangement defined.* A *formal billing arrangement* means an arrangement in which the institution bills only the employer for education furnished by the institution to an individual who is the employer's employee and the institution does not maintain a separate financial account for that individual.

(b) *Requirement to file return*—(1) *In general.* Institutions may elect to report either the information described in paragraph (b)(2) of this section, or the information described in paragraph (b)(3) of this section. Once an institution elects to report under either paragraph (b)(2) or (3) of this section, the institution must use the same reporting method for all calendar years in which it is required to file returns, unless permission is granted to change reporting methods. Paragraph (b)(2) requires institutions to report, among other information, the amount of payments received during the calendar year for qualified tuition and related expenses. Institutions must report separately adjustments made during the calendar year that relate to payments received for qualified tuition and related expenses that were reported for a prior calendar year. For purposes of paragraph (b)(2), an adjustment made to payments received means a reimbursement or refund. Paragraph (b)(3) requires institutions to report, among other information, the amounts billed during the calendar year for qualified tuition and related expenses. Institutions must report separately adjustments made during the calendar year that relate to amounts billed for qualified tuition and related expenses that were reported for a prior calendar year. For purposes of paragraph (b)(3), an adjustment made to amounts billed means a reduction in charges. Insurers must report the information described in paragraph (b)(4) of this section.

(2) *Information reporting requirements for institutions that elect to report payments received for qualified tuition and related expenses*—(i) *In general.* Except as provided in paragraph (a)(2) of this section, an institution reporting payments received for qualified tuition and related expenses must file an information return with the IRS on Form 1098–T, *Tuition Payments Statement*, with respect to each individual enrolled (as determined in paragraph (d)(1) of this section) for an academic period beginning during the calendar year or during a prior calendar year and for whom a reportable transaction described in paragraph (b)(2)(ii) of this section is made during the calendar year. An institution may use a substitute Form 1098–T if the substitute form complies with applicable revenue procedures relating to substitute forms (see § 601.601(d)(2) of this chapter).

(ii) *Information included on return.* An institution reporting payments received for qualified tuition and related expenses must include on Form 1098–T—

(A) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)(41)) of the institution;

(B) The name, address, and TIN of the individual who is, or has been, enrolled by the institution;

(C) The amount of payments of qualified tuition and related expenses from any

source that the institution received with respect to the individual during the calendar year;

(D) An indication by the institution whether any payments received for qualified tuition and related expenses reported for the calendar year relate to an academic period that begins during the first three months of the next calendar year;

(E) The amount of any scholarships or grants for the payment of the individual's costs of attendance that the institution administered and processed during the calendar year;

(F) The amount of any reimbursements or refunds of qualified tuition and related expenses made during the calendar year with respect to the individual that relate to payments of qualified tuition and related expenses that were reported by the institution for a prior calendar year;

(G) The amount of any reductions to the amount of scholarships or grants for the payment of the individual's costs of attendance that were reported by the institution with respect to the individual for a prior calendar year;

(H) An indication by the institution whether the individual was enrolled for at least half of the normal full-time work load for the course of study the individual is pursuing for at least one academic period that begins during the calendar year (see section 25A and the regulations thereunder);

(I) An indication by the institution whether the individual was enrolled in a program leading to a graduate-level degree, graduate-level certificate, or other recognized graduate-level educational credential; and

(J) Any other information required by Form 1098–T and its instructions.

(iii) *Reportable amount of payments received for qualified tuition and related expenses during calendar year determined.* The amount of payments received for qualified tuition and related expenses with respect to an individual during the calendar year that is reportable on Form 1098–T is determined by netting the amount of payments received (as defined in paragraph (b)(2)(v) of this section) for qualified tuition and related expenses during the calendar year against any reimbursements or refunds (as defined in paragraph (b)(2)(vi) of this section) made during the calendar year that relate to payments received for qualified tuition and related expenses during the same calendar year.

(iv) *Separate reporting of reimbursements or refunds of payments of qualified tuition and related expenses that were reported for a prior calendar year.* An institution must separately report on Form 1098–T any reimbursements or refunds (as defined in paragraph (b)(2)(vi) of this section) made during the current calendar year that relate to payments of qualified tuition and related expenses that were reported by the institution for a prior calendar year. Such reimbursements or refunds shall not be netted against the payments received for qualified tuition and related expenses during the current calendar year.

(v) *Payments received for qualified tuition and related expenses determined.* For purposes of determining the amount of payments received for qualified tuition and related expenses during a calendar year, payments received with respect to an individual during the calendar year from any source (except for any scholarship or grant that, by its terms, must be applied to expenses other than qualified tuition and related expenses, such as room and board) are treated as payments of qualified tuition and related expenses up to the total amount billed by the institution for such expenses. For purposes of this section, a payment includes any positive account balance (such as any reimbursement or refund credited to an individual's account) that an institution applies toward current charges.

(vi) *Reimbursements or refunds of payments for qualified tuition and related expenses determined.* For purposes of determining the amount of reimbursements or refunds made of payments received for qualified tuition and related expenses, any reimbursement or refund made with respect to an individual during a calendar year (except for any refund of scholarship or grant that, by its terms, was required to be applied to expenses other than qualified tuition and related expenses, such as room and board), is treated as a reimbursement or refund of payments for qualified tuition and related expenses up to the amount of any reduction in charges for such expenses. For purposes of this section, a reimbursement or refund includes amounts that an institution credits to an individual's account, as well as amounts disbursed to, or on behalf of, the individual.

(vii) *Examples.* The following examples illustrate the rules in this paragraph (b)(2):

Example 1. (i) In early August 2003, University X bills enrolled Student A $10,000 for tuition and $6,000 for room and board for the 2003 Fall semester. In late August 2003, Student A pays $11,000 to University X. In early September 2003, Student A drops to half-time enrollment for the 2003 Fall semester. In late September 2003, University X credits $5,000 to Student A's account, reflecting a $5,000 reduction in charges for qualified tuition and related expenses. In late September 2003, University X applies the $5,000 positive account balance toward current charges.

(ii) Under paragraph (b)(2)(v) of this section, the $11,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. Under paragraph (b)(2)(vi) of this section, the $5,000 credited to the student's account is treated as a reimbursement or refund of payments for qualified tuition and related expenses, because the current year charges for qualified tuition and related expenses were reduced by $5,000. Under paragraph (b)(2)(iii) of this section, University X is required to net the $10,000 tuition payment received during 2003 against the $5,000 reimbursement or refund of payments received for qualified tuition and related expenses during 2003. Therefore, Institution X is required to report $5,000 of payments received for qualified tuition and related expenses during 2003.

Example 2. (i) The facts are the same as in *Example 1*, except that Student A pays the full $16,000 in late August 2003. In late September 2003, University X reduces the tuition charges by $5,000 and issues a $5,000 refund to Student A.

(ii) Under paragraph (b)(2)(v) of this section, the $16,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. Under paragraph (b)(2)(vi) of this section, the $5,000 refund is treated as reimbursement or refund of payments for qualified tuition and related expenses, because the current year charges for qualified tuition and related expenses were reduced by $5,000. Under paragraph (b)(2)(iii) of this section, University X is required to net the $10,000 tuition payment received during 2003 against the $5,000 reimbursement or refund of payments received for qualified tuition and related expenses during 2003. Therefore, Institution X is required to report $5,000 of payments received for qualified tuition and related expenses during 2003.

Example 3. (i) The facts are the same as in *Example 1*, except that Student A is enrolled full-time, and, in early September 2003, Student A decides to live at home with her parents. In late September 2003, University X adjusts Student A's account to eliminate room and board charges and issues a $1,000 refund to Student A.

(ii) Under paragraph (b)(2)(v) of this section, the $11,000 payment is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. Under paragraph (b)(2)(vi) of this section, the

$1,000 refund is not treated as reimbursement or refund of payments for qualified tuition and related expenses, because there is no reduction in charges for qualified tuition and related expenses. Therefore, under paragraph (b)(2)(iii) of this section, University X is required to report $10,000 of payments received for qualified tuition and related expenses during 2003.

Example 4. (i) In early December 2003, College Y bills enrolled Student B $10,000 for tuition and $6,000 for room and board for the 2004 Spring semester. In late December 2003, Student B pays $16,000. In mid-January 2004, after the 2004 Spring semester classes begin, Student B drops to half-time enrollment. In mid-January 2004, College Y credits Student B's account with $5,000, reflecting a $5,000 reduction in charges for qualified tuition and related expenses, but does not issue a refund to Student B. In early August 2004, College Y bills Student B $10,000 for tuition and $6,000 for room and board for the 2004 Fall semester. In early September 2004, College Y applies the $5,000 positive account balance toward Student B's $16,000 bill for the 2004 Fall semester. In late September 2004, Student B pays $6,000 towards the charges.

(ii) Reporting for calendar year 2003. Under paragraph (b)(2)(v) of this section, the $16,000 payment in December 2003 is treated as a payment of qualified tuition and related expenses up to the $10,000 billed for qualified tuition and related expenses. Under paragraph (b)(2)(iii) of this section, College Y is required to report $10,000 of payments received for qualified tuition and related expenses during 2003. In addition, College Y is required to indicate that the payments reported for 2003 relate to an academic period that begins during the first three months of the next calendar year.

(iii) Reporting for calendar year 2004. Under paragraph (b)(2)(vi) of this section, the $5,000 credited to Student B's account is treated as a reimbursement or refund of qualified tuition and related expenses, because the charges for qualified tuition and related expenses were reduced by $5,000. Under paragraph (b)(2)(iv) of this section, the $5,000 reimbursement or refund of qualified tuition and related expenses must be separately reported on Form 1098–T because it relates to payments of qualified tuition and related expenses reported by College Y for 2003. Under paragraph (b)(2)(v) of this section, the $5,000 positive account balance that is applied toward charges for the 2004 Fall semester is treated as a payment. Therefore, College Y received total payments of $11,000 during 2004 (the $5,000 credit plus the $6,000 payment). Under paragraph (b)(2)(v) of this section, the $11,000 of total payments are treated as a payment of qualified tuition and related expenses up to the $10,000 billed for such expenses. Therefore, for 2004, College Y is required to report $10,000 of payments received for qualified tuition and related expenses during 2004 and a $5,000 refund of payments of qualified tuition and related expenses reported for 2003.

(3) *Information reporting requirements for institutions that elect to report amounts billed for qualified tuition and related expenses*—(i) *In general.* Except as provided in paragraph (a)(2) of this section, an institution reporting amounts billed for qualified tuition and related expenses must file an information return on Form 1098–T with respect to each individual enrolled (as determined in paragraph (d)(1) of this section) for an academic period beginning during the calendar year or during a prior calendar year and for whom a reportable transaction described in paragraph (b)(3)(ii) of this section is made during the calendar year. An institution may use a substitute Form 1098–T if the substitute form complies with applicable revenue procedures relating to substitute forms.

(ii) *Information included on return.* An institution reporting amounts billed for qualified tuition and related expenses must include on Form 1098–T—

(A) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)(41)) of the institution;

(B) The name, address, and TIN of the individual who is, or has been, enrolled by the institution;

(C) The amount billed for qualified tuition and related expenses with respect to the individual during the calendar year;

(D) An indication by the institution whether any amounts billed for qualified tuition and related expenses reported for the calendar year relate to an academic period that begins during the first three months of the next calendar year;

(E) The amount of any scholarships or grants for the payment of the individual's costs of attendance that the institution administered and processed during the calendar year;

(F) The amount of any reductions in charges made during the calendar year with respect to the individual that relate to amounts billed for qualified tuition and related expenses that were reported by the institution for a prior calendar year;

(G) The amount of any reductions to the amount of scholarships or grants for the payment of the individual's costs of attendance that were reported by the institution with respect to the individual for a prior calendar year;

(H) An indication by the institution whether the individual was enrolled for at least half of the normal full-time work load for the course of study the individual is pursuing for at least one academic period that begins during the calendar year (see section 25A and the regulations thereunder);

(I) An indication by the institution whether the individual was enrolled in a program leading to a graduate-level degree, graduate-level certificate, or other recognized graduate-level educational credential; and

(J) Any other information required by Form 1098–T and its instructions.

(iii) *Reportable amounts billed for qualified tuition and related expenses during calendar year determined.* The amount billed for qualified tuition and related expenses with respect to an individual during the calendar year that is reportable on Form 1098–T is determined by netting the amounts billed for qualified tuition and related expenses during the calendar year against any reductions in charges for qualified tuition and related expenses made during the calendar year that relate to amounts billed for qualified tuition and related expenses during the same calendar year.

(iv) *Separate reporting of reductions made to amounts billed for qualified tuition and related expenses that were reported for a prior calendar year.* An institution must separately report on Form 1098–T any reductions in charges made during the current calendar year that relate to amounts billed for qualified tuition and related expenses that were reported by the institution for a prior calendar year. Such reductions shall not be netted against amounts billed for qualified tuition and related expenses during the current calendar year.

(v) *Examples.* The following examples illustrate the rules in this paragraph (b)(3):

Example 1. (i) In early August 2003, University X bills enrolled Student A $10,000 for tuition and $6,000 for room and board for the 2003 Fall semester. In late August 2003, Student A pays $11,000 to University X. In early September 2003, Student A drops to half-time enrollment for the 2003 Fall semester. In late September 2003, University X adjusts Student A's account and reduces the tuition charges by $5,000 to reflect half-time enrollment. In late September 2003, University X applies the $5,000 account balance toward current charges.

(ii) Under paragraph (b)(3)(iii) of this section, University X is required to net the $10,000 amount of tuition billed during 2003 against the $5,000 reduction in charges for qualified tuition and related expenses during 2003. Therefore, Institution X is required to report $5,000 in amounts billed for qualified tuition and related expenses during 2003.

Example 2. (i) The facts are the same as in *Example 1*, except that, in addition, in early December 2003, College X bills Student A $10,000 for tuition and $6,000 for room and board for the 2004

Spring semester. In late December 2003, Student A pays $16,000. In mid-January 2004, after the 2004 Spring semester classes begin, Student A drops to half-time enrollment. In mid-January 2004, College X credits $5,000 to Student A's account, reflecting a $5,000 reduction in charges for qualified tuition and related expenses, but does not issue a refund check to Student A. In early August 2004, College X bills Student A $10,000 for tuition and $6,000 for room and board for the 2004 Fall semester. In early September 2004, College X applies the $5,000 positive account balance toward Student A's $16,000 bill for the 2004 Fall semester. In late September 2004, Student A pays $6,000 toward the charges.

(ii) Reporting for calendar year 2003. Under paragraph (b)(3)(iii) of this section, College X is required to report $15,000 amounts billed for qualified tuition and related expenses during 2003 ($5,000 for the 2003 Fall semester and $10,000 for the 2004 Spring semester). In addition, College X is required to indicate that some of the amounts billed for qualified tuition and related expenses reported for 2003 relate to an academic period that begins during the first three months of the next calendar year.

(iii) Reporting for calendar year 2004. Under paragraph (b)(3)(iv) of this section, the $5,000 reduction in charges for qualified tuition and related expenses must be separately reported on Form 1098–T because it relates to amounts billed for qualified tuition and related expenses that were reported by College X for 2003. Under paragraph (b)(3)(iii) of this section, College X is required to report $10,000 in amounts billed for qualified tuition and related expenses during 2004.

(4) *Requirements for insurers*—(i) *In general*. Except as otherwise provided in this section, an insurer must file an information return for each individual with respect to whom reimbursements or refunds of qualified tuition and related expenses are made during the calendar year on Form 1098–T. An insurer may use a substitute Form 1098–T if the substitute form complies with applicable revenue procedures relating to substitute forms (see § 601.601(d)(2) of this chapter).

(ii) *Information included on return*. An insurer must include on Form 1098–T—

(A) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)(41)) of the insurer;

(B) The name, address, and TIN of the individual with respect to whom reimbursements or refunds of qualified tuition and related expenses were made;

(C) The aggregate amount of reimbursements or refunds of qualified tuition and related expenses that the insurer made with respect to the individual during the calendar year; and

(D) Any other information required by Form 1098–T and its instructions.

(5) *Time and place for filing return*—(i) *In general*. Except as provided in paragraphs (b)(5)(ii) and (iii) of this section, Form 1098–T must be filed on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which payments were received, or amounts were billed, for qualified tuition or related expenses, or reimbursements, refunds, or reductions of such amounts were made. An institution or insurer must file Form 1098–T with the IRS according to the instructions to Form 1098–T.

(ii) *Return for nonresident alien individual*. In general, an institution or insurer is not required to file a return on behalf of a nonresident alien individual. However, if a nonresident alien individual requests an institution or insurer to report, the institution or insurer must file a return described in paragraph (b) of this section with the IRS on or before the date prescribed in paragraph (b)(5)(i) of this section, or on or before the thirtieth day after the request, whichever is later.

(iii) *Extensions of time*. The IRS may grant an institution or insurer an extension of time to file returns required in this section upon a showing of good cause. See the instructions to Form 1098–T and applicable revenue procedures for rules relating to extensions of time to file (see § 601.601(d)(2) of this chapter).

(6) *Use of magnetic media*. See section 6011(e) and § 301.6011–2 of this chapter for rules relating to the requirement to file Forms 1098–T on magnetic media.

(c) *Requirement to furnish statement*—(1) *In general*. An institution or insurer must furnish a statement to each individual for whom it is required to file a Form 1098–T. The statement must include—

(i) The information required under paragraph (b) of this section;

(ii) A legend that identifies the statement as important tax information that is being furnished to the IRS;

(iii) Instructions that—

(A) State that the statement reports either total payments received by the institution for qualified tuition and related expenses during the calendar year, or total amounts billed by the institution for qualified tuition and related expenses during the calendar year, or the total reimbursements or refunds made by the insurer;

(B) State that, under section 25A and the regulations thereunder, the taxpayer may claim an education tax credit only with respect to qualified tuition and related expenses actually paid during the calendar year; and that the taxpayer may not be able to claim an education tax credit with respect to the entire amount of payments received, or amounts billed, for qualified tuition and related expenses reported for the calendar year;

(C) State that the amount of any scholarships or grants reported for the calendar year and other similar amounts not reported (because they are not administered and processed by the institution) may reduce the amount of any allowable education tax credit for the taxable year;

(D) State that the amount of any reimbursements or refunds of payments received, or reductions in charges, for qualified tuition and related expenses, or any reductions to the amount of scholarships or grants, reported by the institution with respect to the individual for a prior calendar year may affect the amount of any allowable education tax credit for the prior calendar year;

(E) State that the amount of any reimbursements or refunds of qualified tuition and related expenses reported by an insurer may reduce the amount of an allowable education tax credit for a taxable year;

(F) State that the taxpayer should refer to relevant IRS forms and publications, and should not refer to the institution or the insurer, for explanations relating to the eligibility requirements for, and calculation of, any allowable education tax credit; and

(G) Include the name, address, and phone number of the office or department within the institution or insurer that is the information contact for the institution or insurer that filed the Form 1098–T.

(2) *Time and manner for furnishing statement*—(i) *In general*. Except as provided in paragraphs (c)(2)(ii) and (iii) of this section, an institution or insurer must furnish the statement described in paragraph (c)(1) of this section to each individual for whom it is required to file a return, on or before January 31 of the year following the calendar year in which payments were received, or amounts were billed, for qualified tuition and related expenses, or reimbursements, refunds, or

reductions of such amounts were made. If mailed, the statement must be sent to the individual's permanent address, or the individual's temporary address if the institution or insurer does not know the individual's permanent address. If furnished electronically, the statement must be furnished in accordance with the applicable regulations.

(ii) *Statement to nonresident alien individual.* If an information return is filed for a nonresident alien individual, the institution or insurer must furnish a statement described in paragraph (c)(1) of this section to the individual in the manner and on or before the date prescribed in paragraph (c)(2)(i) of this section, or on or before the thirtieth day after the nonresident alien's request to report, whichever is later.

(iii) *Extensions of time.* The IRS may grant an institution or insurer an extension of time to furnish the statements required in this section upon a showing of good cause. See the instructions to Form 1098–T and applicable revenue procedures for rules relating to extensions of time to furnish statements (see § 601.601(d)(2) of this chapter).

(3) *Copy of Form 1098–T.* An institution or insurer may satisfy the requirement of this paragraph (c) by furnishing either a copy of Form 1098–T and its instructions or another document that contains all of the information filed with the IRS and the information required by paragraph (c)(1) of this section if the document complies with applicable revenue procedures relating to substitute statements (see § 601.601(d)(2) of this chapter).

(d) *Special rules*—(1) *Enrollment determined.* An institution may determine its enrollment for each academic period under its own rules and policies for determining enrollment or as of any of the following dates—

(i) 30 days after the first day of the academic period;

(ii) A date during the academic period on which enrollment data must be collected for purposes of the Integrated Post Secondary Education Data System administered by the Department of Education; or

(iii) A date during the academic period on which the institution must report enrollment data to the State, the institution's governing body, or some other external governing body.

(2) *Payments of qualified tuition and related expenses received or collected by one or more persons*—(i) *In general.* Except as otherwise provided in paragraph (d)(2)(ii) of this section, if a person collects or receives payments of qualified tuition and related expenses on behalf of another person (*e.g.*, an institution), the person collecting or receiving payments must satisfy the information reporting requirements of this section. In this case, the reporting requirements do not apply to the transfer of the payments to the institution.

(ii) *Exception.* If the person collecting or receiving payments of qualified tuition and related expenses on behalf of another person (*e.g.*, an institution) does not possess the information needed to comply with the information reporting requirements of this section, the other person must satisfy the information reporting requirements of this section.

(3) *Governmental units.* An institution or insurer that is a governmental unit, or an agency or instrumentality of a governmental unit, is subject to the information reporting requirements of this section and an appropriately designated officer or employee of the governmental entity must satisfy the information reporting requirements of this section.

(e) *Penalty provisions*—(1) *Failure to file correct returns.* The section 6721 penalty may apply to an institution or insurer that fails to file information returns required by section 6050S and this section on or before the required filing date; that fails to include all of the required information on the return; or that includes incorrect information on the return. See section 6721, and the regulations thereunder, for rules relating to penalties for failure to file correct returns. See section 6724, and the regulations thereunder, for rules relating to waivers of penalties for certain failures due to reasonable cause.

(2) *Failure to furnish correct information statements.* The section 6722 penalty may apply to an institution or insurer that fails to furnish statements required by section 6050S and this section on or before the prescribed date; that fails to include all the required information on the statement; or that includes incorrect information on the statement. See section 6722, and the regulations thereunder, for rules relating to penalties for failure to furnish correct statements. See section 6724, and the regulations thereunder, for rules relating to waivers of penalties for certain failures due to reasonable cause.

(3) *Waiver of penalties for failures to include a correct TIN*—(i) *In general.* In the case of a failure to include a correct TIN on Form 1098–T or a related information statement, penalties may be waived if the failure is due to reasonable cause. Reasonable cause may be established if the failure arose from events beyond the institution's or insurer's control, such as a failure of the individual to furnish a correct TIN. However, the institution or insurer must establish that it acted in a responsible manner both before and after the failure.

(ii) *Acting in a responsible manner.* An institution or insurer must request the TIN of each individual for whom it is required to file a return if it does not already have a record of the individual's correct TIN. If the institution or insurer does not have a record of the individual's correct TIN, then it must solicit the TIN in the manner described in paragraph (e)(3)(iii) of this section on or before December 31 of each year during which it receives payments, or bills amounts, for qualified tuition and related expenses or makes reimbursements, refunds, or reductions of such amounts with respect to the individual. If an individual refuses to provide his or her TIN upon request, the institution or insurer must file the return and furnish the statement required by this section without the individual's TIN, but with all other required information. The specific solicitation requirements of paragraph (e)(3)(iii) of this section apply in lieu of the solicitation requirements of § 301.6724–1(e) and (f) of this chapter for the purpose of determining whether an institution or insurer acted in a responsible manner in attempting to obtain a correct TIN. An institution or insurer that complies with the requirements of this paragraph (e)(3) will be considered to have acted in a responsible manner within the meaning of § 301.6724–1(d) of this chapter with respect to any failure to include the correct TIN of an individual on a return or statement required by section 6050S and this section.

(iii) *Manner of soliciting TIN.* An institution or insurer must request the individual's TIN in writing and must clearly notify the individual that the law requires the individual to furnish a TIN so that it may be included on an information return filed by the institution or insurer. A request for a TIN made on Form W–9S, *Request for Student's or Borrower's Social Security Number and Certification*, satisfies the requirements of this paragraph (e)(3)(iii). An institution or insurer may establish a system for individuals to submit Forms W–9S electronically as described in applicable forms and instructions. An institution or insurer may also develop a separate form to request the individual's TIN or incorporate the request into other forms customarily used by the institution or insurer, such as admission or enrollment forms or financial aid applications.

(4) *Failure to furnish TIN.* The section 6723 penalty may apply to any individual who is required (but fails) to furnish his or her TIN to an institution or insurer. See section 6723, and the regulations thereunder, for rules relating to the penalty for failure to furnish a TIN.

(f) *Effective date.* The rules in this section apply to information returns required to be filed, and information statements required to be furnished, after December 31, 2003.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 5. Section 301.6011–2 is amended by:

1. In paragraph (b)(1), first sentence, add the language "1098–T," immediately after the language "1098–E,".

2. Revising paragraph (g)(3).

The revision reads as follows:

§ 301.6011–2 Required use of magnetic media.

* * * * *

(g) * * *

(3) This section applies to returns on Forms 1098–E and 1098–T filed after December 31, 2003.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on April 26, 2002, 8:45 a.m., and published in the issue of the Federal Register for April 29, 2002, 67 F.R. 20923)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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Bulletin No. 2002–22
June 3, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

SPECIAL ANNOUNCEMENT

Announcement 2002–53, page 1063.
Annual accounting periods; approval. This announcement discusses some of the more significant issues raised in connection with finalizing Notice 2001–34, 2001–23 I.R.B. 1302, and Notice 2001–35, 2001–23 I.R.B. 1314, which proposed procedures for obtaining the Commissioner's approval to adopt, change, or retain an annual accounting period under sections 441 and 442 of the Code.

INCOME TAX

Rev. Rul. 2002–31, page 1023.
Contingent convertible debt instruments. This ruling provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more cash contingent payments.

T.D. 8993, page 1026.
Final regulations under section 1275 of the Code provide guidance on the treatment of annuity contracts issued by an insurance company subject to tax under subchapter L.

REG–154920–01, page 1060.
Proposed regulations under section 954 of the Code provide that gain or loss arising from certain commodities hedging transactions and currency gain or loss arising from certain interest-bearing liabilities do not constitute (or are not netted against) foreign personal holding company income.

EXEMPT ORGANIZATIONS

Announcement 2002–51, page 1063.
Crisis at Home Intervention Center, of San Bruno, CA, no longer qualifies as an organization to which contributions are deductible under section 170 of the Code.

ADMINISTRATIVE

Notice 2002–36, page 1029.
Contingent convertible debt instruments. This notice requests comments and suggestions for change in the relative tax treatment of straight convertible debt instruments and contingent convertible debt instruments. Rev. Rul. 2002–31 sets forth the tax treatment of contingent convertible debt instruments under current law.

Rev. Proc. 2002–37, page 1030.
Changes in accounting periods; automatic approval for corporations. Procedures are provided by which certain corporations may obtain automatic approval of the Commissioner to change their annual accounting period under section 442 of the Code. Rev. Proc. 2000–11 modified, amplified, and superseded.

Rev. Proc. 2002–38, page 1037.
Changes in accounting periods; automatic approval for flowthrough entities. Procedures are provided by which partnerships, S corporations, electing S corporations, and personal service corporations may obtain automatic approval of the Commissioner to adopt, change, or retain an annual accounting period under sections 441 and 442 of the Code. Rev. Proc. 87–32 clarified, modified, amplified, and superseded.

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Department of the Treasury
Internal Revenue Service

Rev. Proc. 2002–39, page 1046.

Annual accounting periods; prior approval. Procedures are provided under sections 441 and 442 of the Code to establish a business purpose and request the prior approval of the Commissioner to adopt, change, or retain an annual accounting period. Rev. Procs. 85–16 and 74–33 superseded.

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Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 163(*l*).—Disallowance of Deduction on Certain Debt Instruments of Corporations

The revenue ruling provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments. See Rev. Rul. 2002–31, on this page.

Section 249.—Limitation on Deduction of Bond Premium on Repurchase

26 CFR 1.249–1: Limitation on deduction of bond premium on repurchase.

The revenue ruling provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments. See Rev. Rul. 2002–31, on this page.

Section 441.—Period for Computation of Taxable Income

26 CFR 1.441–1: Period for computation of taxable income.

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

What significant issues were raised in connection with finalizing Notice 2001–34 and Notice 2001–35, which provided procedures for taxpayers to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period? See Announcement 2002–53, page 1063.

Section 442.—Change of Annual Accounting Period

26 CFR 1.442–1: Change of annual accounting period.

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

What significant issues were raised in connection with finalizing Notice 2001–34 and Notice 2001–35, which provided procedures for taxpayers to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period? See Announcement 2002–53, page 1063.

Section 444.—Election of Taxable Year Other Than Required Taxable Year

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

Section 706.—Taxable Years of Partner and Partnership

26 CFR 1.706–1: Taxable years of partner and partnership.

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

Section 898.—Taxable Year of Certain Foreign Corporations

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

Section 1275.—Other Definitions and Special Rules

26 CFR 1.1275–4: Contingent payment debt instruments.
(Also §§ 163, 249; 1.249–1.)

Contingent convertible debt instruments. This ruling provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more cash contingent payments.

Rev. Rul. 2002–31

ISSUES

Does the noncontingent bond method described in § 1.1275–4(b) of the Income Tax Regulations apply to a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments? If so,

how is the comparable yield determined, and does either § 163(*l*) or § 249 of the Internal Revenue Code affect the issuer's ability to deduct the interest that accrues on the instrument under the noncontingent bond method?

FACTS

On January 1, 2002, Corporation *X* issues for $625*x* a 20-year debt instrument with a stated principal amount of $1,000*x*. Except for the contingent interest payments described below, the debt instrument does not provide for any stated interest. The debt instrument is convertible at any time into a number of shares of Corporation *X* common stock having a value, on the date of issue of the debt instrument, that is significantly less than $625*x*. The debt instrument is part of an issue that is not marketed or sold in substantial part to persons for whom the inclusion of interest from the instruments in the issue is not expected to have a substantial effect on their U.S. tax liability.

The debt instrument provides that, beginning after January 1, 2005, interest ("contingent interest") is payable for any six-month period ending on June 30 or December 31 if the average market price of the instrument for a measurement period before the applicable six-month period is greater than 120 percent of the instrument's accreted value. Under the terms of the debt instrument, accreted value is defined as the issue price of the instrument plus the economic accrual to any date of determination of a portion of the difference between the issue price and the stated principal amount at maturity. The amount of contingent interest that is payable is equal to the greater of (1) the regular cash dividend per share of Corporation *X* common stock for the six-month period multiplied by the number of shares into which the debt instrument may be converted, or (2) *y* percent of the average market price of the debt instrument for the measurement period. The contingent interest is neither a remote nor an incidental contingency within the meaning of § 1.1275–2(h).

On or after January 1, 2005, Corporation *X* has the option to redeem the debt instrument for cash in an amount equal to the instrument's accreted value as of the date the instrument is redeemed. In addition, the holder of the debt instrument has the option to put the debt instrument to Corporation *X* on January 1, 2005, or January 1, 2012, for an amount equal to the instrument's accreted value as of each such date. If the holder exercises this option, Corporation *X* can satisfy its obligation with cash, shares of Corporation *X* common stock, or a combination of cash and shares of Corporation *X* common stock, in each case having a total value equal to the instrument's accreted value. Taking into account both the likelihood of conversion of the debt instrument and the likelihood that the instrument will be put by the holder, it is not substantially certain that a substantial amount of the principal or interest on the debt instrument will be required to be paid in stock or will be payable in stock at the option of the issuer.

Corporation *X* takes the position that the noncontingent bond method applies to the debt instrument and that the comparable yield for the instrument is 7 percent, compounded semiannually. (To determine the comparable yield under § 1.1275–4(b), Corporation *X* used the yield at which it would issue a comparable fixed-rate, nonconvertible debt instrument.) In preparing the projected payment schedule required by the noncontingent bond method, Corporation *X* projects payments of contingent interest and a payment at maturity (based on a projected exercise of the conversion privilege) in an amount sufficient to cause the yield on the debt instrument to equal 7 percent, compounded semiannually. When the debt instrument was issued, the long-term applicable Federal rate (AFR) was 5.39 percent, compounded semiannually.

LAW AND ANALYSIS

Section 1.1275–4 provides rules for the treatment of contingent payment debt instruments. In general, if a contingent payment debt instrument is issued for cash or publicly traded property, the noncontingent bond method applies to the instrument. *See* § 1.1275–4(b). Under the noncontingent bond method, interest accrues on the debt instrument as if it were a fixed-payment debt instrument. This fixed-payment debt instrument is constructed by using the instrument's comparable yield and a projected payment schedule.

In general, under § 1.1275–4(b)(4)(i), the comparable yield for a contingent payment debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. Relevant terms and conditions include the level of subordination, term, timing of payments, and general market conditions. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. In all cases, the yield must be a reasonable yield for the issuer and may not be less than the AFR. In certain situations, the comparable yield is presumed to be the AFR. *See* § 1.1275–4(b)(4)(i)(B).

The projected payment schedule for a debt instrument includes each noncontingent payment and a projected amount for each contingent payment. *See* § 1.1275–4(b)(4)(ii). In general, if a contingent payment is based on market information, the amount of the projected payment is the forward price of the contingent payment. If a contingent payment is not based on market information, the amount of the projected payment is the expected value of the contingent payment as of the issue date. If the projected payment schedule and the instrument's issue price do not produce the comparable yield, then the schedule must be adjusted to produce the comparable yield. In most cases, the issuer's determination of the projected payment schedule will be respected unless it was set with a principal purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. *See* § 1.1275–4(b)(4)(v).

If the actual amount of a contingent payment is different from the projected payment, then the difference is taken into account as either a positive or negative adjustment. A positive adjustment results when the actual amount is greater than the projected amount. In general, a net positive adjustment is treated as interest and is includible in income by the holder and deductible by the issuer in the taxable year in which the adjustment occurs. A negative adjustment results when the actual amount is less than the projected amount. In general, a net negative adjustment (1) reduces interest accruals on the debt instrument for the taxable year, (2)

to the extent of any excess, is treated as an ordinary loss by a holder and ordinary income by the issuer, but only to the extent of prior accruals on the debt instrument by the holder or issuer, and (3) to the extent of any further excess, is a carryforward to the next taxable year. *See* § 1.1275–4(b)(6) for the specific rules that apply to negative and positive adjustments.

Except as provided in § 1.1275–4(a)(2), § 1.1275–4 applies to any debt instrument that provides for one or more contingent payments. A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. *See* § 1.1275–2(h) for rules relating to remote and incidental contingencies.

In addition, a debt instrument does not provide for contingent payments merely because it provides for an option to convert the instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt. Section 1.1275–4(a)(4). However, this exception does not apply when the debt instrument provides for contingent payments other than the conversion feature and those contingent payments are neither remote nor incidental.

Although the debt instrument issued by Corporation *X* provides for an option described in § 1.1275–4(a)(4), the debt instrument also provides for one or more contingent payments (the contingent interest) that are neither remote nor incidental. As a result, the debt instrument is a contingent payment debt instrument subject to the noncontingent bond method described in § 1.1275–4(b). Although a conversion feature alone does not cause a convertible debt instrument to be subject to the noncontingent bond method, the possibility of a conversion is nevertheless a contingency. Therefore, the comparable yield for a convertible debt instrument subject to the noncontingent bond method is determined under § 1.1275–4(b) by reference to comparable fixed-rate nonconvertible debt instruments. Moreover, the projected payment schedule is determined by treating the stock received upon a conversion of the debt instrument as a contingent payment.

Under § 1.163–7, the amount of interest that is deductible each year on a contingent payment debt instrument is determined under § 1.1275–4. Therefore, for purposes of § 163(a), Corporation *X* computes its interest deductions for each year the debt instrument is outstanding based on the comparable yield of 7 percent, compounded semiannually. Based on the facts set forth above, the original issue discount anti-abuse rule in § 1.1275–2(g) does not apply because the result reached is not unreasonable in light of the purposes of § 163(e), §§ 1271 through 1275, or any related section of the Code. The anti-abuse rule, therefore, does not affect Corporation *X*'s ability to compute its interest deductions based on the comparable yield of 7 percent, compounded semiannually.

Certain provisions of the Internal Revenue Code, such as § 163(*l*) and § 249, may affect an issuer's ability to deduct the interest computed under the noncontingent bond method.

Section 163(*l*), which was added to the Internal Revenue Code by the Taxpayer Relief Act of 1997, § 1005, 1997–4 (Vol. 1) C.B. 125, provides that no deduction is allowed for any interest paid or accrued on a disqualified debt instrument, which is any indebtedness of a corporation that is payable in equity of the issuer or a related party. Under § 163(*l*), indebtedness is payable in equity only if (A) a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into, such equity, (B) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity, or (C) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in either (A) or (B) above. Principal or interest is required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised.

The conference report on the 1997 legislation indicates that an instrument is treated as payable in stock if it is part of an arrangement designed to result in payment with or by reference to such stock, including certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. The conference report further states that it is not expected that § 163(*l*) will affect debt with a conversion feature if the conversion price is significantly higher than the market price of the stock on the issue date of the debt. *See* H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 523–24 (1997), 1997–4 (Vol. 2) C.B. 1993–94.

Under the terms of the debt instrument issued by Corporation *X*, none of the instrument's principal or interest is required to be determined by reference to the value of Corporation *X*'s stock. Although the value of Corporation *X*'s stock is used in constructing the debt instrument's projected payment schedule, this projected payment is not determinative in applying § 163(*l*) to the instrument. Under the noncontingent bond method, the projected payment schedule is a mechanism for comparing actual payments to projected payments and then applying the rules for negative and positive adjustments.

The debt instrument will be paid in stock on conversion and may be paid in stock, at the option of Corporation *X*, if the holder exercises its put option. Nevertheless, it is not substantially certain that a substantial amount of the principal or interest on the debt instrument will be required to be paid in stock or will be payable in stock at the option of Corporation *X*. Therefore, the debt instrument is not a disqualified debt instrument under § 163(*l*), and § 163(*l*) does not bar Corporation *X*'s accrual of interest deductions based on the comparable yield of 7 percent, compounded semiannually.

Section 249 provides that no deduction is allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note or certificate or other evidence of indebtedness that is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of

indebtedness that are not convertible. However, § 249 does not apply to the extent the corporation can demonstrate to the satisfaction of the Secretary that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature. *See* § 1.249–1. For purposes of § 249, a conversion is a repurchase. *See Clark Equipment Company v. United States*, 912 F.2d 113 (6th Cir. 1990). *See also* §§ 1.61–12(c)(2) and 1.163–7(c).

Section 249 was added to the Internal Revenue Code in 1969 because, in the case of a premium paid upon a corporation's repurchase of its convertible indebtedness, Congress believed that the amount of the premium in excess of the cost of borrowing is not analogous to an interest expense or deductible business expense. Instead, the amount is paid in a capital transaction analogous to a corporation's repurchase of its common stock and, therefore, is not deductible. H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess. 1, 110 (1969), 1969–3 C.B. 200, 269; S. Rep. No. 552, 91st Cong., 1st Sess. 1, 149 (1969), 1969–3 C.B. 423, 518.

Section 249 applies only to a premium paid to repurchase a convertible debt instrument. Therefore, § 249 does not affect Corporation *X*'s ability to deduct accruals of interest based on the comparable yield. However, § 249 applies to a conversion of the debt instrument into stock having a value in excess of the debt instrument's adjusted issue price. *See Clark Equipment; National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982); and § 1.249–1. Therefore, this excess is not deductible by Corporation *X*, except to the extent the excess does not exceed a normal call premium under § 1.249–1(d) or Corporation *X* can demonstrate that the excess is attributable to the cost of borrowing and not to the conversion feature.

HOLDINGS

The noncontingent bond method described in § 1.1275–4(b) applies to the convertible debt instrument issued by Corporation *X*. The yield at which Corporation *X* would issue a comparable fixed rate nonconvertible debt instrument is used to determine the instrument's comparable yield and, therefore, the accruals of interest on the instrument. In addition, the debt instrument is not a disqualified debt instrument under § 163(*l*). Moreover, § 249 does not affect Corporation *X*'s ability to deduct periodic interest accruals on the debt instrument. However, if the debt instrument is converted into Corporation *X* stock having a value in excess of the debt instrument's adjusted issue price, Corporation *X* may not be able to deduct this excess under § 249.

DRAFTING INFORMATION

The principal authors of this revenue ruling are William E. Blanchard and Dale S. Collinson of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Blanchard at (202) 622–3950 and Mr. Collinson at (202) 622–3900 (not toll-free calls).

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26 CFR 1.1275–1: Definitions.

T.D. 8993

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Debt Instruments With Original Issue Discount; Annuity Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the federal income tax treatment of annuity contracts issued by certain insurance companies. The regulations provide guidance on whether certain annuity contracts are excluded from the definition of a debt instrument under the original issue discount provisions of the Internal Revenue Code.

DATES: *Effective Date*: These regulations are effective June 6, 2002.

Applicability Dates: For dates of applicability, see § 1.1275–1(k)(3).

FOR FURTHER INFORMATION CONTACT: Patrick E. White, (202) 622–3920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Sections 163(e) and 1271 through 1275 of the Internal Revenue Code (Code) provide rules for the treatment of debt instruments with original issue discount (OID). Section 1275(a)(1)(A) defines the term *debt instrument* to include a bond, debenture, note, or certificate or other evidence of indebtedness. Sections 1275(a)(1)(B)(i) and (ii), however, exclude certain annuity contracts from the definition of a debt instrument. This document contains rules concerning the exception for annuities described in section 1275(a)(1)(B)(ii). A notice of proposed rulemaking (REG–125237–00, 2001–12 I.R.B. 919) was published in the **Federal Register** (66 FR 2852) on January 12, 2001. One individual commented anonymously on the proposed regulations. The individual primarily expressed concern that the proposed guidance should not limit the investment options of U.S. investors. No public hearing was requested or held. The proposed regulations are adopted as proposed.

Explanation of Provisions

In general, the OID provisions apply to issuers and holders of debt instruments. The term debt instrument generally means any instrument or contractual arrangement that constitutes indebtedness under general principles of income tax law. See section 1275(a)(1)(A) and § 1.1275–1(d) of the Income Tax Regulations.

If a contract is a debt instrument with OID, section 1272 generally requires the holder of the contract to include OID in income currently on a constant yield basis, regardless of the holder's overall method of accounting. By contrast, the holder of an annuity contract to which section 72 applies generally is allowed to

defer recognizing economically earned income until distributions are made on the contract.

Section 1275(a)(1)(B) excepts two types of annuity contracts from the definition of a debt instrument. First, section 1275(a)(1)(B)(i) excepts an annuity contract to which section 72 applies if the contract "depends (in whole or in substantial part) on the life expectancy of 1 or more individuals." Second, section 1275(a)(1)(B)(ii) excepts an annuity contract to which section 72 applies under certain circumstances if the contract "is issued by an insurance company subject to tax under subchapter L (or by an entity described in section 501(c) and exempt from tax under section 501(a) which would be subject to tax under subchapter L were it not so exempt)...."

The regulations provide that an annuity contract issued by a foreign insurance company is treated under section 1275(a)(1)(B)(ii) as issued by an insurance company subject to tax under subchapter L if the insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract. The IRS and Treasury conclude that this is the most appropriate application of the language of section 1275(a)(1)(B)(ii) and is consistent with the use of that phrase elsewhere in the Code and regulations. See, *e.g.*, sections 953(e)(3)(C) and 1297(b)(2)(B); § 1.848–2(h).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Patrick E. White, Office of the Associate Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1271–0 is amended by adding entries for paragraphs (k) through (k)(3) to § 1.1275–1 to read as follows:

§ 1.1271–0 Original issue discount; effective dates; table of contents.

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§ 1.1275–1 Definitions.

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(k) Exception under section 1275(a)(1)(B)(ii) for annuities issued by an insurance company subject to tax under subchapter L of the Internal Revenue Code.

(1) Rule.

(2) Examples.

(3) Effective date.

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Par. 3. Section 1.1275–1 is amended by adding paragraph (k) to read as follows:

§ 1.1275–1 Definitions.

* * * * *

(k) *Exception under section 1275(a)(1)(B)(ii) for annuities issued by an insurance company subject to tax under subchapter L of the Internal Revenue Code*—(1) *Rule*. For purposes of section 1275(a)(1)(B)(ii), an annuity contract issued by a foreign insurance company is considered as issued by an insurance company subject to tax under subchapter L if the insurance company is subject to tax under subchapter L with respect to income earned on the annuity contract.

(2) *Examples*. The following examples illustrate the rule of paragraph (k)(1) of this section. Each example assumes that the annuity contract is a contract to which section 72 applies and was issued in a transaction where there is no consideration other than cash or another qualifying annuity contract, pursuant to the exercise of an election under an insurance contract by a beneficiary thereof on the death of the insured party, or in a transaction involving a qualified pension or employee benefit plan. The examples are as follows:

Example 1. Company X is an insurance company that is organized, licensed and doing business in Country Y. Company X does not have a U.S. trade or business and is not, under section 842, subject to U.S. income tax under subchapter L with respect to income earned on annuity contracts. A, a U.S. taxpayer, purchases an annuity contract from Company X in Country Y. The annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 2. The facts are the same as in *Example 1*, except that Company X has a U.S. trade or business. A purchased the annuity from Company X's U.S. trade or business. Under section 842(a), Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Under these facts, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 3. The facts are the same as in *Example 2*, except that there is a tax treaty between Country Y and the United States. Company X is a resident of Country Y for purposes of the U.S.-Country Y tax treaty. Company X's activities in the U.S. do not constitute a permanent establishment under the U.S.-Country Y tax treaty. Because Company X does not have a U.S. permanent establishment, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 4. The facts are the same as in *Example 1*, except that Company X is a foreign insurance corporation controlled by a U.S. shareholder. Company X does not make an election under section 953(d) to be treated as a domestic corporation. The controlling U.S. shareholder is required under sections 953 and 954 to include income earned on the annuity contract in its taxable income under subpart F. However, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 5. The facts are the same as in *Example 4*, except that Company X properly elects under section 953(d) to be treated as a domestic corporation. By reason of its election, Company X is subject to tax under subchapter L with respect to income

earned on the annuity contract. Thus, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

(3) *Effective date*. This paragraph (k) is applicable for interest accruals on or after June 6, 2002. This paragraph (k) does not apply to an annuity contract that was purchased before January 12, 2001. For purposes of this paragraph (k), if any additional investment in a contract purchased before January 12, 2001, is made on or after January 12, 2001, and the additional investment is not required to be made under a binding written contractual obligation that was entered into before that date, then the additional investment is treated as the purchase of a contract after January 12, 2001.

David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

Approved April 26, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 6, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 7, 2002, 67 F.R. 30547)

Section 1378.—Taxable Year of S Corporation

26 CFR 1.1378–1: Taxable year of S corporation.

What procedures apply for partnerships, S corporations, electing S corporations, and personal service corporations to obtain the automatic approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–38, page 1037.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

Section 1502.—Regulations

26 CFR 1.1502–76: Taxable year of members of group.

What procedures apply for corporations to obtain the automatic approval of the Commissioner to change their annual accounting period? See Rev. Proc. 2002–37, page 1030.

What procedures apply for taxpayers to obtain the prior approval of the Commissioner to adopt, change, or retain an annual accounting period? See Rev. Proc. 2002–39, page 1046.

Contingent Convertible Debt Instruments—Request for Comments

Notice 2002–36

Rev. Rul. 2002–31, 2002–22 I.R.B., dated June 3, 2002, provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments (contingent convertible debt instruments). The revenue ruling holds that, in the described circumstances, the noncontingent bond method described in § 1.1275–4(b) of the Income Tax Regulations applies to these debt instruments. In addition, the revenue ruling addresses how an issuer determines the comparable yield used to determine the interest accruals, the effect of § 163(*l*) of the Internal Revenue Code on the accruals, and the consequences of a conversion of the instrument, including the application of § 249. See Rev. Rul. 2002–31 for a discussion of these issues.

The Internal Revenue Service and the Treasury Department are aware that the contingent convertible debt instruments described in the revenue ruling have been the subject of considerable comment within the tax bar and the media regarding whether the applicable tax rules are those generally governing contingent debt instruments or those generally governing convertible debt instruments. Existing regulations dealing with contingent debt instruments establish a general rule that issuers of such instruments are required to accrue interest expense (and holders are required to accrue interest income) as if the debt instruments bore a yield equal to the rate at which an issuer would issue a comparable debt instrument. However, certain convertible debt instruments are generally excluded from the application of the noncontingent bond method.

Specifically, § 1.1275–4(a)(4) provides that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt. Because of this exclusion from the noncontingent bond method for straight convertible debt (that is, debt with no contingencies other than the conversion privilege described in § 1.1275–4(a)(4)), issuers and holders of such instruments accrue interest expense and income at a yield that assumes the instrument will not be converted (the nonconversion yield). That yield generally is considerably less than the yield for a comparable nonconvertible debt instrument. By contrast, if a convertible debt instrument providing for the possible payment of additional interest upon the occurrence of particular contingencies is eligible for the application of the noncontingent bond method, relatively insignificant changes in the investment economics of a convertible debt instrument can effect a dramatic change in the amount of interest accruals.

Some commentators have argued that the general approach of the noncontingent bond method, which requires issuers and holders of contingent debt instruments to accrue interest income and expense based on the yield of comparable debt instruments, is economically sound. They argue that the exclusion of straight convertible debt from this general approach simply reflects the historical treatment of convertible debt instruments but is otherwise inconsistent with the economic rationale for the general rule. Accordingly, these commentators argue for limited application of the exclusion for straight convertible debt and assert that sound policy supports the application of the comparable yield methodology to contingent convertible debt instruments.

Other commentators support the exclusion for straight convertible debt (or have assumed its continued existence) and have questioned whether contingent convertible debt instruments should be subject to the comparable yield methodology, particularly if the result is to permit an issuer to deduct interest accruals based on the yield of comparable nonconvertible debt instruments. These commentators have suggested that the discontinuity between the treatment of straight convertible debt and the treatment of contingent convertible debt instruments could be eliminated, or substantially ameliorated, by requiring use of the nonconversion yield on a straight convertible debt instrument as the comparable yield for accruals on contingent convertible debt instruments under the noncontingent bond method.

Several commentators have focused attention on the rule that only remote and incidental contingencies are disregarded in determining whether a debt instrument is a contingent debt instrument. See §§ 1.1275–4(a)(5) and 1.1275–2(h). To the extent that § 1.1275–4 takes into account contingent payments that are relatively unlikely to occur (but not so unlikely as to be remote) and relatively insignificant in amount (but not so insignificant as to be incidental), the narrow scope of the exception tends to make largely elective the exclusion of straight convertible debt from the noncontingent bond method. That is, through changes in the terms of debt instruments that result in relatively small economic differences, issuers can trigger the application of the comparable yield methodology. Critics of this result have suggested an expansion of the universe of contingent payments that are disregarded in determining whether debt is contingent debt.

As a policy matter, the Service and the Treasury are concerned whenever significantly different tax results obtain for economically similar financial instruments, such as (1) straight convertible debt and (2) convertible debt that provides for contingent payments that, while not remote or incidental, are relatively insignificant in amount or in likelihood of occurrence. Such inconsistencies create market inefficiencies and increased transactional expense.

Disparate tax treatment for economically similar financial instruments exists in other instances, however, and the means for achieving equivalent tax treatment may not be clear or acceptable. With respect to contingent convertible debt instruments, for example, differing considerations support competing answers to the question of whether the comparable yield used for interest accruals should be based on a comparable nonconvertible debt instrument or a comparable convertible debt instrument.

Referring to nonconvertible debt instruments to ascertain the comparable yield is more consistent with the economic rationale underlying the comparable yield methodology, although using the nonconversion yield of convertible debt instruments would minimize the cliff effect and discontinuity in tax treatment that result when a contingent convertible debt instrument ceases to be eligible for the exclusion and becomes subject to the comparable yield methodology.

Similarly, changing the rule disregarding remote and incidental contingencies, which applies to nonconvertible debt instruments as well as convertible debt instruments, could have broader effects than simply reducing the cliff effect of adding contingent interest to a convertible debt instrument. The rule generally simplifies administration by avoiding the necessity of applying the comparable yield methodology (and the associated requirements for payment projections and adjustments for differences between projected payments and actual payments) to instruments having contingent payments that are insignificant in amount or unlikely to occur. Any expansion of the rule could cause the universe of instruments to which the comparable yield methodology is inapplicable to include cases in which the possibility of contingent payments has a significant depressing effect on the noncontingent yield on the instrument. The result would be the accrual of income and deduction in amounts less than the true economic yield on the instrument.

* * *

The Service and the Treasury are concerned whenever issuers and their counsel are uncertain about the tax consequences of new financial instruments that are widely used and broadly traded in the capital markets. The capital markets operate most efficiently when the tax treatment of various financial instruments is clear. To resolve the existing controversy and to eliminate confusion in the marketplace, Rev. Rul. 2002–31 sets forth the position of the Service and the Treasury regarding the tax treatment of contingent convertible debt instruments under current law and regulations. This notice invites comments and suggestions for changes in the relative tax treatment of straight convertible debt instruments and contingent convertible debt instruments to eliminate or reduce the disparity in treatment of these instruments.

The Service and the Treasury invite comments and suggestions for the use of existing regulatory authority (including regulatory authority under § 1275(d)), as well as other administrative measures, to modify the rules governing the tax treatment of straight convertible debt instruments and contingent convertible debt instruments. Specifically, comments and suggestions are invited on whether the exclusion from the noncontingent bond method for straight convertible debt instruments should be eliminated, expanded, or modified; whether the rules for determining a comparable yield for purposes of applying the noncontingent bond method to a contingent convertible debt instrument should be revised to require comparison with a straight convertible debt instrument; and whether the rule that remote and incidental contingencies are disregarded in determining whether a debt instrument is a contingent debt instrument should be modified.

As part of the discussion of the tax treatment of contingent convertible debt instruments, some commentators also have raised issues regarding whether it is appropriate as a matter of public policy to allow issuers deductions for interest accruals on convertible debt instruments to the extent that payment of the accrued interest can ultimately be effected only by the issuance of the issuer's stock. Sections 163(*l*) and 249 contain restrictions on the deductibility of amounts based on the value of an issuer's stock, but those restrictions have limited scope. See the discussion of §§ 163(*l*) and 249 in Rev. Rul. 2002–31. Persons responding to this request for comments may want to include a discussion of how the policies underlying §§ 163(*l*) and 249 relate to suggestions they may make for changes in regulations or other administrative measures.

The Service and the Treasury note that in Notice 2000–29, 2000–1 C.B. 1241, they had previously requested comments on certain federal tax consequences of options to acquire partnership interests and partnership debt instruments convertible into partnership interests. Persons responding to this invitation for comments and suggestions may want to include a discussion of whether a suggested treatment of convertible debt instruments issued by corporations also should apply to similar instruments issued by partnerships.

Please submit all comments by August 30, 2002. Written comments should be sent to:

Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–36)
Room 5226
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered between the hours of 8 a.m. and 5 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–36)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, comments may be submitted electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2002–36" in the subject line. All comments will be available for public inspection and copying in their entirety.

The principal authors of this notice are Dale S. Collinson and William E. Blanchard of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Mr. Collinson at (202) 622–3900 and Mr. Blanchard at (202) 622–3950 (not toll-free calls).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 442, 706, 898, 1502; 1.442–1, 1.706–1, 1.1502–76.)

Rev. Proc. 2002–37

CONTENTS

SECTION 1. PURPOSE

This revenue procedure provides the exclusive procedures for certain corporations to obtain automatic approval to change their annual accounting period under § 442 of the Internal Revenue Code and § 1.442–1(b) of the Income Tax Regulations. This revenue procedure modifies, amplifies, and supersedes Rev. Proc. 2000–11, 2000–3 C.B. 309. A corporation complying with all the applicable provisions of this revenue procedure will be deemed to have established a business purpose and obtained the approval of the Commissioner of the Internal Revenue Service to change its annual accounting period under § 442 and the regulations thereunder.

SECTION 2. BACKGROUND

.01 *Taxable Year Defined.*

(1) *In general.* Section 441(b) and § 1.441–1(b)(1) provide that the term "taxable year" generally means the taxpayer's annual accounting period, if it is a calendar or fiscal year, or, if applicable, the taxpayer's required taxable year.

(2) *Annual accounting period.* Section 441(c) and § 1.441–1(b)(3) provide that the term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

(3) *Required taxable year.* Section 1.441–1(b)(2) provides that certain taxpayers must use the particular taxable year that is required under the Code and the regulations thereunder. See § 1.441–1(b)(2) for examples of taxpayers, including certain corporations, with required taxable years.

.02 *Change in Taxable Year.*

(1) In general. Section 1.442–1(a)(1) generally provides that a taxpayer that wants to change its annual accounting period and use a new taxable year must obtain the approval of the Commissioner.

(2) *Annualization of short period return.* Section 443(b) and § 1.443–1(b)(1)(i) generally provide that if a return is made for a short period resulting from a change of an annual accounting period, the taxable income for the short period must be placed on an annual basis by multiplying the income by 12 and dividing the result by the number of months in the short period. Unless § 443(b)(2) and § 1.443–1(b)(2) apply, the tax for the short period generally is the same part of the tax computed on an annual basis as the number of months in the short period is of 12 months. But see, for example, §§ 1.852–3(e), 1.857–2(a)(4), and 1.1502–76 for exceptions to this general rule for a regulated investment company (RIC), a real estate investment trust (REIT), and a subsidiary corporation ceasing to be a member of a consolidated group, respectively.

(3) *No retroactive change in annual accounting period.* Unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in annual accounting period, regardless of whether the change is to a required taxable year.

.03 *Approval of a Change.* Section 1.442–1(b) provides, in part, that in order to secure the approval of the Commissioner to change an annual accounting

period, a taxpayer must file an application, generally on Form 1128, *Application to Adopt, Change, or Retain a Tax Year,* with the Commissioner within such time and in such manner as is provided in administrative procedures published by the Commissioner. In general, a change in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the change.

SECTION 3. SIGNIFICANT CHANGES

Significant changes to Rev. Proc. 2000–11 made by this revenue procedure include:

.01 Section 4.01(1) of this revenue procedure provides that this revenue procedure is the exclusive procedure for corporations within its scope to change their annual accounting period;

.02 Section 4.01(2) of this revenue procedure waives only certain scope restrictions for changes to (or from) a 52–53-week taxable year that references the same calendar month;

.03 Section 4.01(3) of this revenue procedure provides that a corporation that wants to change to or retain a natural business year that satisfies the 25-percent gross receipts test described in section 5.05 of this revenue procedure, or to a 52–53-week taxable year ending with reference to such taxable year, may do so under this revenue procedure notwithstanding certain of the limitations imposed under section 4.02;

.04 Section 4.02(1) of this revenue procedure reduces the period of time required between a prior accounting period change and a change effected under this revenue procedure from 6 calendar years to 48 months;

.05 Section 4.02(1) of this revenue procedure also adds to the list of accounting period changes that will not be considered prior changes for purposes of the 48-month rule: (a) a change to comply with § 1.1502–75, (b) any prior change made by a corporation whose majority shareholder has changed its taxable year within the last 12 months if the corporation wants to change to that shareholder's taxable year in order to file consolidated financial statements, and (c) a change to a required taxable year or an ownership taxable year;

.06 Section 4.02(2) of this revenue procedure adds to the list of corporations with certain pass-through interests that are ineligible to use this revenue procedure certain shareholders of a closely-held REIT;

.07 Section 4.02(2) of this revenue procedure also incorporates into this list of potentially prohibited pass-through interests an interest in a controlled foreign corporation (CFC), foreign personal holding company (FPHC), or passive foreign investment company (PFIC) and, as a result, allows an exception for *de minimis* interests in these entities;

.08 Section 4.02(2)(b) of this revenue procedure provides that, in certain cases in which a partnership is owned 50-percent by each of two partners, the corporate partner's interest in the partnership will be disregarded;

.09 Section 4.02(8) of this revenue procedure provides an exception to the scope restrictions for a CFC or FPHC that wants to change to its required taxable year;

.10 Section 4.02(12) of this revenue procedure adds to the list of corporations ineligible to use this revenue procedure a corporation not otherwise described in this revenue procedure that has a required taxable year, unless that corporation is changing to its required taxable year;

.11 Section 6.04 of this revenue procedure now provides certain exceptions to the record keeping/book conformity rule; and

.12 Section 6.08 of this revenue procedure adds a term and condition to prevent the carryback of capital losses generated in the short period.

SECTION 4. SCOPE

.01 *Applicability.* (1) *In general.* Except as provided in section 4.02, this revenue procedure, which is the exclusive procedure for corporations within its scope, applies to a corporation requesting automatic approval to change its annual accounting period.

(2) *Certain 52–53-week taxable years.* This revenue procedure applies to a corporation (including a member of a consolidated group) that wants to change to (or from) a 52–53-week taxable year, subject to the provisions of section 4.02 of this revenue procedure. However, notwithstanding sections 4.02(1), (2), (3), (6), (8), and (11) of this revenue procedure, this revenue procedure applies to a corporation (including a member of a consolidated group) that wants to change from a 52–53-week taxable year that references a particular month to a non–52–53-week taxable year that ends on the last day of that month, and vice versa.

(3) *Natural business year.* Notwithstanding sections 4.02(2) and (3) of this revenue procedure, this revenue procedure applies to a corporation that wants to change to a natural business year that satisfies the 25-percent gross receipts test described in section 5.

(4) *Section 898 election.* Notwithstanding section 4.02 of this revenue procedure, this revenue procedure applies to a CFC (as defined in § 957) that wants to revoke its one-month deferral election under § 898(c)(1)(B) and change its taxable year to the majority U.S. shareholder year (as defined in § 898(c)(1)(C)).

.02 *Inapplicability.* This revenue procedure does not apply to the following corporations:

(1) *Prior change.* A corporation that has changed its annual accounting period at any time within the most recent 48–month period ending with the last month of the requested taxable year. For this purpose, the following changes will not be considered a change in annual accounting period:

(a) a prior change in accounting period by a corporation in order to comply with the common taxable year requirement of either § 1.1502–75(d)(3)(v) or 1.1502–76(a)(1). See § 1.442–1(d);

(b) a prior change in accounting period by a corporation either acquired within the last 12 months, or whose majority shareholder changed its taxable year within the last 12 months, if that corporation currently wants to change to the taxable year of its majority shareholder with which it does not file consolidated tax returns in order to file consolidated financial statements. For purposes of this section 4.02(1)(b), "majority shareholder" means ownership that satisfies the test of § 1504(a)(2), substituting "more than 50 percent" for "at least 80 percent;"

(c) a prior change from a 52–53-week taxable year that references a particular month to a non–52–53-week taxable year that ends on the last day of that month, and vice versa; or

(d) a prior change in accounting period to a required taxable year or an ownership taxable year.

(2) *Interest in a pass-through entity*. A corporation that has an interest in a pass-through entity as of the end of the short period. However, an interest in a pass-through entity will be disregarded for this purpose if any of the following conditions are met:

(a) the pass-through entity would be required under the Code or regulations to change its taxable year to the new taxable year of the corporation (or, if applicable in the case of a CFC or FPHC, to a taxable year that begins one month-earlier than the new taxable year of the corporation). See section 6.10 of this revenue procedure for a special term and condition related to this exception;

(b) the pass-through entity is a partnership that is owned 50-percent by each of two partners and the corporation and the partnership both want to change to the taxable year of the other 50-percent partner. See section 6.10 of this revenue procedure for a special term and condition related to this exception;

(c) the new taxable year of the corporation would result in no change in or less deferral (as described in § 1.706–1(b)(3)) from the pass-through entity than the present taxable year of the corporation. If the pass-through entity is a partnership, CFC, or FPHC, the corporation should compare the existing deferral period (between the pass-through entity's and the corporation's current taxable years) with the new deferral period (between the new required taxable year of the pass-through entity and the corporation's new taxable year). See section 4.04 of this revenue procedure for an example of this rule; or

(d) for pass-through entities not qualifying for the exceptions in either section 4.02(2)(a) or (b) of this revenue procedure, the pass-through entity in which the corporation has an interest has been in existence for at least 3 taxable years and the interest is *de minimis*. For this purpose, an interest in a pass-through entity is *de minimis* only if:

(i) for each of the prior 3 taxable years of the corporation, the amount of income (including ordinary income or loss, capital gains or losses, rents, royalties, interest, dividends and deduction equivalents of credits) from such pass-through entity is less than or equal to (A) 5 percent of the corporation's gross receipts (or, in the case of a member of a consolidated group, the consolidated group's gross receipts) for those taxable years, and (B) $500,000; and

(ii) the amount of income from all such pass-through entities in the aggregate is less than or equal to the amounts described in (A) and (B) above. See section 4.04 of this revenue procedure for an example of this rule;

(3) *Shareholder of certain FSCs or IC-DISCs*. A corporation that is a shareholder of a foreign sales corporation (FSC) or interest charge domestic international sales corporation (IC-DISC), as of the end of the short period. However, an interest in a FSC or IC-DISC is disregarded if either of the following conditions is met:

(a) the FSC or IC-DISC in which the corporation is the principal shareholder (*i.e.*, the shareholder with the highest percentage of voting power as defined in § 441(h)) would be required to change its taxable year pursuant to §§ 1.921–1T(b)(4) and (b)(6) to the new taxable year of the corporation. See section 6.10 of this revenue procedure for a special term and condition related to this exception; or

(b) the new taxable year of the corporation would result in no change in or less deferral of income (as determined under the principles of § 1.706–1(a)(3)) from the FSC or IC-DISC than the present taxable year of the corporation;

(4) *FSC or an IC-DISC*. A corporation that is a FSC or an IC-DISC. See § 1.921–1T(b)(4) for rules regarding automatic changes of the annual accounting period of a FSC or IC-DISC to the taxable year of its principal shareholder;

(5) *S corporation*. A corporation that is an S corporation (as defined in § 1361). See Rev. Proc. 2002–38, 2002–22 I.R.B. 1037, for procedures to follow for certain automatic changes in the annual accounting period of an S corporation;

(6) *Electing S corporation*. A corporation that attempts to make an S corporation election for the taxable year immediately following the short period, unless the change is to a permitted taxable year;

(7) *PSC*. A corporation that is a personal service corporation (PSC) (as defined in § 441(i)). See Rev. Proc. 2002–38 for procedures to follow for certain automatic changes in the annual accounting period of a PSC;

(8) *CFC or FPHC*. A corporation that is a CFC (as defined in § 957), including a CFC that is also a PFIC (as defined in § 1297(a)), or a FPHC (as defined in § 552), unless the CFC or FPHC either does not have a required taxable year under final regulations under § 898, or is changing to its required taxable year or to a 52–53-week taxable year that references its required taxable year;

(9) *Tax-exempt organization*. A corporation that is a tax-exempt organization, other than an organization exempt from federal income tax under §§ 521, 526, 527, or 528. See Rev. Proc. 85–58, 1985–2 C.B. 740, for procedures to follow in changing an annual accounting period of a tax-exempt organization that is not within the scope of this revenue procedure;

(10) *Possessions corporation*. A corporation that has in effect an election under § 936;

(11) *Cooperative association*. A corporation that is a cooperative association (within the meaning of § 1381(a)) with a loss in the short period required to effect the change of annual accounting period, unless the patrons of the cooperative association are substantially the same in the year before the change of annual accounting period, in the short period required to effect the change, and in the year following the change. For purposes of this subsection, "substantially the same" means that ownership of more than 90 percent of the cooperative association's stock is owned by the same members; or

(12) *Corporation with a required taxable year*. A corporation that is not described in sections 4.02(1) through (11) of this revenue procedure that has a required taxable year (*e.g.*, a REIT, or a qualified settlement fund or designated settlement fund as defined in § 1.468B),

unless the corporation is changing to its required taxable year.

.03 *Nonautomatic Changes.* Corporations that are unable to obtain automatic approval for a change in accounting period under this revenue procedure, the applicable regulations, or any other revenue procedure must secure prior approval from the Commissioner for a change in an accounting period pursuant to § 442 and the regulations thereunder. *See* Rev. Proc. 2002–39, 2002–22 I.R.B. 1046.

.04 *Examples.*

(1) Example 1. (i) Corporations V, W, X, Y, and Z hold equal 20 percent interests in the capital and profits of partnership ABC. V and W are calendar year taxpayers. X and Y have taxable years ending June 30, and Z has a taxable year ending September 30. ABC does not have a business purpose for a particular taxable year, and thus, pursuant to § 1.706–1, ABC is required to use a taxable year ending June 30 because that taxable year results in the least aggregate deferral of income to its partners. Z currently has a 3-month deferral period (the number of months from the end of ABC's taxable year to the end of Z's taxable year). Z wants to change its taxable year to a calendar year.

(ii) If Z changes its taxable year to a calendar year, ABC would be required to change its taxable year under § 706 to its majority interest taxable year, which is the calendar year. As a result of Z's new taxable year and ABC's new taxable year, Z's deferral period would be eliminated. Because Z's new taxable year would reduce Z's deferral, Z may disregard its interest in ABC under section 4.02(2)(c) of this revenue procedure.

(2) *Example 2.* (i) Corporation X, a calendar year taxpayer, wants to change its taxable year to a year ending June 30. X has interests in five partnerships, ABC, DEF, GHI, JKL, and MNO. All of the partnerships have been in existence for over three taxable years. X's interests in each of ABC and DEF is greater than 50 percent. X's interest in GHI, JKL, and MNO is 15 percent, 10 percent, and 5 percent, respectively. GHI uses the majority interest taxable year ending May 31 and JKL and MNO each use their respective majority interest taxable year ending December 31. X's distributive share of income/(loss) from JKL for the prior three taxable years is $300,000, $(100,000), and $200,000, respectively, and from MNO is $300,000, $200,000, and $100,000, respectively. X's gross receipts for each of those same taxable years was $15,000,000.

(ii) X's interests in its pass-through entities will be disregarded only if each pass-through entity satisfies one of the exceptions enumerated under section 4.02(2) of this revenue procedure. In the instant case, X's interests in ABC and DEF each meet the exception in section 4.02(2)(a) because X is the majority interest partner in each partnership. X's interest in GHI meets the exception in section 4.02(2)(c) because X's new taxable year would result in less deferral than its old taxable year (the deferral between May 31 and June 30 of 1 month as compared to the deferral between May 31 and December 31 of 7 months). Because X is not the majority interest partner in JKL and MNO and because its new taxable year would not result in less deferral from these partnerships, X's interests in JKL and MNO may be disregarded only if they satisfy the *de minimis* exception in section 4.02(2)(d). Although the income from JKL and MNO for each of the prior three taxable years is less than 5 percent of X's gross receipts and $500,000, the income for year 1 from JKL and MNO, in the aggregate ($300,000 and $300,000), exceeds the $500,000 amount specified in section 4.02(2)(d)(ii). Consequently, JKL and MNO fail to satisfy the *de minimis* exception in section 4.02(2)(d). Because X's interests in all of its pass-through entities will not be disregarded, X is not within the scope of this revenue procedure.

SECTION 5. DEFINITIONS

The following definitions apply solely for the purpose of this revenue procedure:

.01 *Corporation.* The term "corporation" includes associations, joint-stock companies, and insurance companies, as provided in § 7701(a)(3), and includes each member of a consolidated group. However, the common parent of a consolidated group may change the group's annual accounting period under this revenue procedure if every member of the consolidated group meets all the requirements and complies with all the conditions of this revenue procedure.

.02 *Pass-through Entity.* The term "pass-through entity" means a partnership; a trust; an estate; a common trust fund (as defined in § 584); a CFC (as defined in § 957), but only to the extent the corporation is a U.S. shareholder (as defined in § 951(b)); an FPHC (as defined in § 552), but only to the extent the corporation is a U.S. shareholder (as defined in § 551(a)); a PFIC, but only if the corporation has elected to treat such PFIC as a qualified electing fund (as defined in § 1295); and a closely-held REIT (as defined in § 6655(e)(5)(B)), but only to the extent the corporation is described in § 6655(e)(5)(A).

.03 *Required Taxable Year.* The required taxable year is the particular taxable year that certain taxpayers are required to use under the Code and the regulations thereunder. See § 1.441–1(b)(2) for examples of taxpayers, including certain corporations, with required taxable years.

.04 *Permitted Taxable Year.* A "permitted taxable year" of an electing S corporation is the required taxable year; a taxable year elected under § 444; a natural business year that satisfies the 25-percent gross receipts test described in section 5.06 of this revenue procedure; the ownership taxable year; or a 52–53-week taxable year that references the required taxable year, taxable year elected under § 444, natural business year, or ownership taxable year.

.05 *Ownership Taxable Year.* An "ownership taxable year" of an electing S corporation is the taxable year (if any) that, as of the first day of the first effective year, constitutes the taxable year of one or more shareholders (including any shareholder that concurrently changes to such taxable year) holding more than 50-percent of the corporation's issued and outstanding shares of stock. For this purpose, under principles similar to § 1.706–3T for determining the taxable year of a partnership, a shareholder that is tax-exempt under § 501(a) is disregarded if such shareholder is not subject to tax on any income attributable to the electing S corporation. Tax-exempt shareholders are not disregarded, however, if the electing S corporation is wholly-owned by such tax-exempt entities. A shareholder in an electing S corporation that wants to concurrently change its taxable year must follow the instructions generally applicable to taxpayers changing their taxable years contained in § 1.442–1(b), Rev. Proc. 2002–39, or any other applicable administrative procedure published by the Commissioner.

.06 *Natural Business Year.* A corporation establishes a "natural business year" under this revenue procedure by satisfying the following "25-percent gross receipts test:"

(1) *Prior three years gross receipts.*

(a) Gross receipts from sales and services for the most recent 12-month period that ends with the last month of

the requested annual accounting period are totaled and then divided into the amount of gross receipts from sales and services for the last 2 months of this 12-month period.

(b) The same computation as in (1)(a) above is made for the two preceding 12-month periods ending with the last month of the requested annual accounting period.

(2) *Natural business year.*

(a) Except as provided in (b) below, if each of the three results described in (1) equals or exceeds 25 percent, then the requested annual accounting period is deemed to be the taxpayer's natural business year.

(b) The taxpayer must determine whether any annual accounting period other than the requested annual accounting period also meets the 25-percent gross receipts test described in (2)(a). If one or more other annual accounting periods produce higher averages of the three percentages (rounded to 1/100 of a percent) described in (1) than the requested annual accounting period, then the requested annual accounting period will not qualify as the taxpayer's natural business year.

(3) *Special rules.* (a) To apply the 25-percent gross receipts test for any particular year, the taxpayer must compute its gross receipts under the method of accounting used to prepare its federal income tax returns for such taxable year.

(b) Regardless of the taxpayer's method of accounting, the taxpayer's share of income from a pass-through entity generally must be reported as gross receipts in the month that the pass-through entity's taxable year ends.

(c) If a taxpayer has a predecessor organization and is continuing the same business as its predecessor, the taxpayer must use the gross receipts of its predecessor for purposes of computing the 25-percent gross receipts test.

(d) If the taxpayer (including any predecessor organization) does not have a 47-month period of gross receipts (36-month period for requested taxable year plus additional 11-month period for comparing requested taxable year with other potential taxable years), then it cannot establish a natural business year under this revenue procedure.

(e) If the requested taxable year is a 52–53-week taxable year, the calendar month ending nearest to the last day of the 52–53-week taxable year is treated as the last month of the requested taxable year for purposes of computing the 25-percent gross receipts test.

.07 *First Effective Year.* The first effective year is the first taxable year for which a change in annual accounting period is effective, *e.g.*, the short period required to effect the change. Thus, in the case of a change, the first effective year is the short period required to effect the change. The first effective year is also the first taxable year for complying with all the terms and conditions set forth in this revenue procedure necessary to effect the change in annual accounting period.

.08 *Short Period.* A corporation's short period is the period beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year.

SECTION 6. TERMS AND CONDITIONS OF CHANGE

.01 *In General.* A change in annual accounting period filed under this revenue procedure must be made pursuant to the terms and conditions provided in this revenue procedure.

.02 *Short Period Tax Return.* The corporation must file a federal income tax return for the short period required to effect a change in annual accounting period by the due date of that return, including extensions pursuant to § 1.443–1(a). The corporation's taxable income for the short period must be annualized and the tax must be computed in accordance with the provisions of § 443(b) and § 1.443–1(b). However, for changes to (or from) a 52–53-week taxable year referencing the same month as the current (or requested) taxable year, see special rules in § 1.441–2.

.03 *Subsequent Year Tax Returns.* Returns for subsequent taxable years generally must be made on the basis of a full 12 months (or on a 52–53-week basis) ending on the last day of the requested taxable year, unless the corporation secures the approval of the Commissioner to change that taxable year.

.04 *Record Keeping/Book Conformity.* The books of the corporation must be closed as of the last day of the first effective year. Thereafter, the corporation must compute its income and keep its books and records (including financial statements and reports to creditors) on the basis of the requested taxable year, except that this requirement shall not apply (1) to books and records maintained solely for foreign law purposes (*e.g.*, foreign tax reporting purposes), or (2) if the requested taxable year is the corporation's required taxable year.

.05 *Changes in Natural Business Year.* If an electing S corporation changes to a natural business year that satisfies the 25-percent gross receipts test under this revenue procedure and that annual accounting period no longer qualifies as a natural business year, the taxpayer is using an impermissible annual accounting period and should change to a permitted taxable year or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner. Certain S corporations may qualify for automatic approval to change their annual accounting period under Rev. Proc. 2002–38. Other taxpayers must request approval under Rev. Proc. 2002–39.

.06 *Changes in Ownership Taxable Year.* An electing S corporation that changes to an ownership taxable year under this revenue procedure must change to a permitted taxable year or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner, or request approval to retain its current taxable year, if, as of the first day of any taxable year, its ownership taxable year changes. Certain S corporations may qualify for automatic approval to change or retain their annual accounting period under Rev. Proc. 2002–38. Other taxpayers must request approval under Rev. Proc. 2002–39.

.07 *52–53-week Taxable Years.* If applicable, the corporation must comply with § 1.441–2(e) (relating to the timing of taking items into account in those cases where the taxable year of a pass-through entity ends with reference to the same calendar month as one or more of its owners).

.08 *Creation of Net Operating Loss or Capital Loss.* If the corporation generates a net operating loss (NOL) or capital loss (CL) in the short period required to effect a change in annual accounting period, the corporation may not carry the NOL or CL

back, but must carry it over in accordance with the provisions of §§ 172 and 1212, respectively, beginning with the first taxable year after the short period. However, the short period NOL or CL is carried back or carried over in accordance with §§ 172 or 1212, respectively, if it is either: (a) $50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL or CL for a full 12-month period beginning with the first day of the short period.

.09 *Creation of General Business Credits*. If there is an unused general business credit or any other unused credit generated in the short period, the corporation must carry that unused credit forward. An unused credit from the short period may not be carried back.

.10 *Concurrent Change for Related Entities*. If a corporation's interest in a pass-through entity, FSC, or IC-DISC (related entity) is disregarded pursuant to section 4.02(2)(a), 4.02(2)(b), or 4.02(3)(a) of this revenue procedure because the related entity is required to change its taxable year to the corporation's new taxable year (or, if applicable in the case of a CFC or FPHC, to a taxable year beginning one month earlier than the corporation's new taxable year), the related entity must change its taxable year concurrently with the corporation's change in taxable year, either under Rev. Proc. 2002–38, Rev. Proc. 2002–39, or this revenue procedure, whichever is applicable. This related party change is required notwithstanding the testing date provisions in §§ 706(b)(4)(A)(ii), 898(c)(1)(C)(ii), § 1.921–1T(b)(6), and the special provision in § 706(b)(4)(B).

SECTION 7. GENERAL APPLICATION PROCEDURES

.01 *Approval*. Approval is hereby granted to any corporation within the scope of this revenue procedure to change its annual accounting period, provided the corporation complies with all the applicable provisions of this revenue procedure. Approval is granted beginning with the first effective year. A corporation granted approval under this revenue procedure to change its annual accounting period is deemed to have established a business purpose for the change to the satisfaction of the Commissioner.

.02 *Filing Requirements*.

(1) *Where to file*. Any corporation (including the common parent of a consolidated group) that wants to change its annual accounting period pursuant to the provisions of this revenue procedure must complete and file a Form 1128 with the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the corporation files its federal income tax return. No copies of Form 1128 are required to be sent to the national office. The corporation also must attach a copy of the Form 1128 to the federal income tax return filed for the short period required to effect the change. Any corporation completing and filing a Form 1128 on behalf of a CFC or FPHC must file the Form 1128 where the corporation files its federal income tax return.

(2) *When to file*. A Form 1128 filed pursuant to this revenue procedure will be considered timely filed for purposes of § 1.442–1(b)(1) only if it is filed on or before the due date (including extensions) for filing the federal income tax return for the short period required to effect such change.

(3) *Label*. In order to assist in the processing of the change in annual accounting period, reference to this revenue procedure must be made a part of the Form 1128 by either typing or legibly printing the following statement at the top of page 1 of the Form 1128: "FILED UNDER REV. PROC. 2002–37." For a CFC that is revoking a § 898(c)(1)(B) election under section 4.01(4) of this revenue procedure, the label at the top of page 1 of the Form 1128 should read "REVOCATION OF § 898(c)(1)(B) ELECTION FILED UNDER REV. PROC. 2002–37."

(4) *Signature requirements*. The Form 1128 must be signed on behalf of the corporation requesting the change of annual accounting period by an individual with authority to bind the corporation in such matters. If the corporation is a member of a consolidated group, the Form 1128 must be signed by a duly authorized officer of the common parent. If an agent is authorized to represent the corporation before the Service, to receive the original or a copy of correspondence concerning the application, or to perform any other act(s) regarding the application on behalf of the corporation, a power of attorney reflecting such authorization(s) should be attached to the application. A corporation's representative without a power of attorney to represent the corporation will not be given any information about the application.

(5) *No user fee*. A user fee is not required for an application filed under this revenue procedure and, except as provided in section 8.01 of this revenue procedure, the receipt of an application filed under this revenue procedure may not be acknowledged.

(6) *Additional information*. In the case of a corporation changing to a natural business year that satisfies the 25–percent gross receipts test described in section 5.06 of this revenue procedure, the corporation must supply the gross receipts for the most recent 47 months for itself (or any predecessor) in compliance with the instructions to Form 1128.

(7) *Consolidated application*. A common parent must file a single application to change the annual accounting period of its consolidated group, even if one or more of the subsidiaries of the group are requesting to use a 52–53-week taxable year that ends with reference to the common parent's requested taxable year or the subsidiaries are requesting to use a taxable year consisting of 12 calendar months that coincides with the reference month of the common parent's requested 52–53-week taxable year. *See* § 1.1502–76(a)(1) (common parent must attach a statement to its tax return as required by Rev. Proc. 89–56, 1989–2 C.B. 643, and comply with Rev. Rul. 72–184, 1972–1 C.B. 289). On the Form 1128 filed on behalf of a common parent and its subsidiaries, the common parent corporation must clearly indicate which corporations in the consolidated group (if any) are requesting a 52–53-week taxable year, and which (if any) are requesting a taxable year consisting of 12 calendar months. In addition, the common parent must answer all relevant questions on the Form 1128 for each member of the consolidated group.

SECTION 8. REVIEW OF APPLICATION

.01 *Service Center Review*. A Service Center may deny a change of annual accounting period under this revenue procedure only if (a) the Form 1128 is not filed timely, or (b) the corporation fails to

meet the scope or any term and condition of this revenue procedure. If the change is denied, the Service Center will return the Form 1128 with an explanation for the denial.

.02 *Review of Director*. The appropriate director may ascertain if the change in annual accounting period was made in compliance with all the applicable provisions of this revenue procedure. Corporations changing their annual accounting period pursuant to this revenue procedure without complying with all the provisions (including the terms and conditions) of this revenue procedure ordinarily will be deemed to have initiated the change in annual accounting period without the approval of the Commissioner. Upon examination, a corporation that has initiated an unauthorized change of annual accounting period may be denied the change. For example, the corporation may be required to recompute its taxable income or loss in accordance with its former (or required, if applicable) taxable year.

SECTION 9. EFFECTIVE DATE AND TRANSITION RULE

.01 *Effective Date*. This revenue procedure generally is effective for all changes in annual accounting periods for which the first effective year ends on or after May 10, 2002. However, if the time period for filing Form 1128 with respect to a taxable year set forth in section 7.02(2) of this revenue procedure has not yet expired, a corporation within the scope of this revenue procedure may elect early application of the revenue procedure by providing the notification set forth in section 7.02(3) on the top of page 1 of Form 1128 and by satisfying the other procedural requirements of section 7.

.02 *Transition Rule*. If a corporation within the scope of this revenue procedure filed an application with the national office and the application is pending with the national office on May 10, 2002, the corporation may obtain approval under this revenue procedure. However, the national office will process the application in accordance with the authority under which it was filed, unless by the later of June 25, 2002, or the issuance of the letter ruling granting or denying approval for the change, the corporation notifies the national office that it wants to use this revenue procedure. If the corporation timely notifies the national office that it wants to use this revenue procedure, the national office will require the corporation to make appropriate modifications to the application to comply with the applicable provisions of this revenue procedure. In addition, any user fee that was submitted with the application will be refunded to the corporation.

SECTION 10. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000–11 is modified, amplified, and superseded.

SECTION 11. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1786. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are found in sections 7 and 10. The information in section 7 is required in order to determine whether the taxpayer properly obtained automatic approval to change its annual accounting period. The information in section 10 is required in order to allow a corporation to apply the provisions of this revenue procedure to a pending application. The likely respondents are corporations.

The estimated total annual reporting burden for the requirements contained in section 7 of this revenue procedure is reflected in the burden estimates for Form 1128. The estimated total annual reporting burden for the requirement contained in section 10 of this revenue procedure is 50 hours: the estimated annual burden per respondent is 30 minutes; the estimated number of respondents is 100; and the estimated frequency of response is once.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Roy A. Hirschhorn and Martin Scully, Jr. of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Hirschhorn or Mr. Scully at (202) 622–4960 (not a toll-free call).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 441, 442, 444, 706, 1378; 1.441–1, 1.441–3, 1.442–1, 1.706–1, 1.1378–1.)

Rev. Proc. 2002–38

CONTENTS

SECTION 1. PURPOSE

This revenue procedure provides the exclusive procedures for certain partnerships, S corporations, electing S corporations (as defined in section 5.02), and personal service corporations (PSCs) to obtain automatic approval to adopt, change, or retain their annual accounting period under § 442 of the Internal Revenue Code and § 1.442–1(b) of the Income Tax Regulations. This revenue procedure clarifies, modifies, amplifies, and supersedes Rev. Proc. 87–32, 1987–2 C.B. 396. A partnership, S corporation, electing S corporation, or PSC complying with the applicable provisions of this revenue procedure will be deemed to have established a business purpose and obtained the approval of the Commissioner of the Internal Revenue Service to adopt, change, or retain its annual accounting period under § 442 and the regulations thereunder.

SECTION 2. BACKGROUND

.01 *Taxable Year Defined.*

(1) *In general.* Section 441(b) and § 1.441–1(b)(1) provide that the term "taxable year" generally means the taxpayer's annual accounting period, if it is a calendar year or fiscal year, or, if applicable, the taxpayer's required taxable year.

(2) *Annual accounting period.* Section 441(c) and § 1.441–1(b)(3) provide that the term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

(3) *Required taxable year.*

(a) *In general.* Section 1.441–1(b)(2) provides that certain taxpayers must use the particular taxable year that is required under the Code and the regulations thereunder. For example, as described below, a partnership, S corporation, or PSC has a required taxable year that generally conforms to the taxable year of its owners. H.R. Rep. No. 99–841 (Conf. Rep.), 99th Cong., 2d Sess., II–318 (1986), 1986–3 (Vol. 4) C.B. 319. Exceptions are provided for certain taxpayers, including a partnership, S corporation, or PSC, that make an election under § 444, elect to use a 52–53-week taxable year that ends with reference to its required taxable year or a taxable year elected under § 444, or establish a business purpose for having a different taxable year and obtain approval under § 442.

(b) *Partnerships.* Section 706(b) and § 1.706–1(b)(2) generally provide that a partnership's taxable year must be its required taxable year. However, a partnership may have a taxable year other than its required taxable year if it makes an election under § 444, elects to use a 52–53-week taxable year that ends with reference to its required taxable year or a taxable year elected under § 444, or establishes a business purpose for having a different taxable year and obtains the approval of the Commissioner under § 442. The required taxable year for a partnership is:

(i) the taxable year of one or more of its partners who have an aggregate interest in partnership profits and capital of greater than 50 percent;

(ii) if there is no taxable year described in clause (i), the taxable year of all the principal partners of the partnership (*i.e.*, all the partners having an interest of 5 percent or more in partnership profits or capital); or

(iii) if there is no taxable year described in clause (i) or (ii), the taxable year that results in the least aggregate deferral of income to the partners.

(c) *S corporations*. Section 1378 and § 1.1378–1(a) provide that the taxable year of an S corporation must be a permitted year. The term "permitted year" means (1) the required taxable year (*i.e.*, a taxable year ending on December 31), (2) a taxable year elected under § 444, (3) a 52–53-week taxable year ending with reference to the required taxable year or a taxable year elected under § 444, or (4) any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Commissioner.

(d) *PSCs*. Section 441(i)(1) and § 1.441–3 provide that the taxable year of a PSC must be the calendar year unless the PSC makes an election under § 444, elects to use a 52–53-week taxable year that ends with reference to the calendar year or a taxable year elected under § 444, or establishes, to the satisfaction of the Commissioner, a business purpose for having a different period for its taxable year.

.02 *Adoption of a Taxable Year*. A newly-formed partnership, S corporation, or PSC may adopt its required taxable year, a taxable year elected under § 444, or a 52–53-week taxable year ending with reference to its required taxable year or a taxable year elected under § 444 without the approval of the Commissioner pursuant to § 441. If, however, a partnership, S corporation, or PSC wants to adopt any other taxable year, it must establish a business purpose and obtain approval under § 442. *See* § 1.441–1(c).

.03 *Change in Taxable Year*.

(1) *In general*. Section 1.442–1(a) generally provides that a taxpayer that wants to change its annual accounting period and use a new taxable year must obtain the approval of the Commissioner.

(2) *Annualization of short period return*. Section 443(b) and § 1.443–1(b)(1)(i) provide that if a return is made for a short period resulting from a change of an annual accounting period, the taxable income for the short period must be placed on an annual basis by multiplying the income by 12 and dividing the result by the number of months in the short period. Unless § 443(b)(2) and § 1.443–1(b)(2) apply, the tax for the short period generally is the same part of the tax computed on an annual basis as the number of months in the short period is of 12 months. But see §§ 1.706–1(b)(8)(i)(B) and 1.1378–1(c)(2) for exceptions to this general rule for partnerships and S corporations, respectively.

(3) *No retroactive change in annual accounting period*. Unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in annual accounting period, regardless of whether the change is to a required taxable year.

.04 *Retention of a Taxable Year*. In certain cases, a partnership, S corporation, electing S corporation, or PSC will be required to change its taxable year unless it establishes a business purpose and obtains the approval of the Commissioner under § 442, or makes an election under § 444, to retain its current taxable year. *See* § 1.441–1(d). For example, a corporation on a June 30 fiscal year that either becomes a PSC or elects to be an S corporation, and as a result is required to use the calendar year, must obtain the approval of the Commissioner to retain its current fiscal year. Similarly, a partnership using a taxable year that corresponds to its required taxable year generally must obtain the approval of the Commissioner to retain that taxable year if its required taxable year changes as a result of a change in ownership. *But see* § 706 (b)(4)(B). However, a partnership that has previously established a business purpose to the satisfaction of the Commissioner to use a particular fiscal year is not required to obtain the approval of the Commissioner to retain such fiscal year if its required taxable year changes.

.05 *Approval of an Adoption, Change, or Retention*. Section 1.442–1(b) provides that in order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, with the Commissioner within such time and in such manner as is provided in administrative procedures published by the Commissioner. In general, an adoption, change, or retention in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention.

.06 *Business Purpose*.

(1) *Sufficient business purposes*. Section 1.442–1(b)(2) provides that generally the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's required taxable year, ownership taxable year, or natural business year. Section 1.442–1(b)(2) also provides that, in the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners, will not be treated as a business purpose.

(2) *Natural business year*. A taxpayer is deemed to have established a natural business year if it satisfies the "25-percent gross receipts test." *See* Rev. Proc. 83–25, 1983–1 C.B. 689, superseded by Rev. Proc. 87–32. The Conference Report to the Tax Reform Act of 1986 states that the Secretary may prescribe other tests in addition to the 25-percent gross receipts test to be used to establish the existence of a business purpose if, in the discretion of the Secretary, such tests are desirable and expedient towards the efficient administration of the tax laws. *See* H.R. Rep. No. 99–841 (Conf. Rep.), 99th Cong., 2d Sess., II–318 (1986), 1986–3 (Vol. 4) C.B. 319.

.07 *Section 444 Elections*. A partnership, S corporation, electing S corporation, or PSC generally can elect under § 444 to use a taxable year other than its required taxable year, but only if the deferral period of the taxable year elected is not longer than the shorter of 3 months or the deferral period of the taxable year being changed. A partnership and an S corporation with a § 444 election must

make required payments under § 7519 that approximate the amount of deferral benefit and a PSC with a § 444 election is subject to the minimum distribution requirements of § 280H. A taxpayer may automatically adopt, change to, or retain a taxable year permitted under § 444 by filing a Form 8716, *Election to Have a Taxable Year Other Than a Required Taxable Year.* A taxpayer that wants to terminate its § 444 election must follow the automatic procedures under § 1.444–1T(a)(5) to change to its required taxable year or establish a business purpose for using a different taxable year pursuant to § 442, the regulations thereunder, and Rev. Proc. 2002–39, 2002–22 I.R.B. 1046, or this revenue procedure (whichever is applicable).

SECTION 3. SIGNIFICANT CHANGES

Significant changes to Rev. Proc. 87–32 made by this revenue procedure include:

.01 Section 4.01(1) of this revenue procedure clarifies that a partnership, S corporation, electing S corporation, or PSC may change automatically to its required taxable year;

.02 Section 4.01(2) of this revenue procedure allows a partnership, S corporation, electing S corporation, or PSC to change automatically to a natural business year that satisfies the 25-percent gross receipts test, regardless of whether such year results in more deferral of income than its present taxable year;

.03 Sections 4.01(1), (2), and (3) of this revenue procedure allow, in appropriate circumstances, a partnership, S corporation, electing S corporation, or PSC to adopt, change to, or retain a 52–53-week taxable year ending with reference to the required taxable year, natural business year, or ownership taxable year;

.04 Section 4.01(4) of this revenue procedure allows any partnership, S corporation, electing S corporation, or PSC to automatically change from a 52–53-week taxable year to a non–52–53-week taxable year that ends with reference to the same calendar month, and vice versa;

.05 Section 4.01(5) of this revenue procedure allows a partnership that would be required to change its taxable year because of a minor percentage change in ownership to retain its current taxable year for one year, subject to certain circumstances;

.06 Section 4 of this revenue procedure allows a PSC to automatically change its taxable year even if the PSC makes an S corporation election for the taxable year immediately following the short period;

.07 Sections 4.02(1)-(4) of this revenue procedure generally prevent a partnership, S corporation, electing S corporation, or PSC from using this revenue procedure to change its annual accounting period if the taxpayer is under examination and does not obtain consent from the appropriate director, or is before an area office or before a federal court and its annual accounting period is an issue under consideration;

.08 Section 4.02(5) of this revenue procedure reduces the period of time required between a prior accounting period change and a change effected under this revenue procedure from 6 calendar years to 48 months, and provides that a change to a required or ownership taxable year, and a change to (or from) a 52–53-week taxable year from (or to) a non-52–53-week taxable year ending with reference to the same calendar month, will not be considered changes within the most recent 48-month period;

.09 Section 5.06 of this revenue procedure has been expanded to disregard the interests of certain tax-exempt entities for purposes of determining the ownership taxable year of an S corporation or electing S corporation, unless the S corporation or electing S corporation is wholly-owned by such tax-exempt entities;

.10 Section 6.04 of this revenue procedure adds a term and condition requiring the taxpayer to compute its income and keep its books and records (including financial statements) on the basis of the requested taxable year, except in certain circumstances;

.11 Section 6.08 of this revenue procedure adds a term and condition to prevent the carryback of certain capital losses generated in the short period;

.12 Section 7.02(2) of this revenue procedure extends the filing requirements for filing a Form 1128 to the due date of the taxpayer's federal income tax return (including extensions) for the first effective year; and

.13 Section 8.01 provides audit protection for partnerships, S corporations, electing S corporations, or PSCs that change their annual accounting period under this revenue procedure.

SECTION 4. SCOPE

.01 *Applicability*. Except as provided in section 4.02, this revenue procedure, which is the exclusive procedure for taxpayers within its scope to secure the Commissioner's approval, applies to:

(1) *Required taxable year*. A partnership, S corporation, electing S corporation, or PSC that wants to change to its required taxable year (as defined in section 5.03 of this revenue procedure), or to a 52–53-week taxable year ending with reference to such taxable year;

(2) *Natural business year*. A partnership, S corporation, electing S corporation, or PSC (other than a member of a tiered structure as defined in § 444 and § 1.444–2T) that wants to change to or retain a natural business year that satisfies the 25-percent gross receipts test described in section 5.05 of this revenue procedure, or to a 52–53-week taxable year ending with reference to such taxable year;

(3) *Ownership taxable year*. An S corporation or electing S corporation that wants to adopt, change to, or retain its ownership taxable year (as defined in section 5.06 of this revenue procedure), or a 52–53-week taxable year ending with reference to such taxable year;

(4) *Certain 52–53-week taxable years*. A partnership, S corporation, electing S corporation, or PSC that wants to change from a 52–53-week taxable year that references a particular calendar month to a non–52–53-week taxable year that ends on the last day of the same calendar month, and vice versa; and

(5) *Certain changes in ownership of partnerships*. A partnership that is required to change its taxable year under § 706(b)(1)(B) because of a change in its ownership may continue to use its current taxable year for a period of one taxable year, provided that:

(A) the change in ownership is less than 10 percent of all partners' aggregate interests in partnership profits and capital; and

(B) it is reasonably foreseeable that, at the end of one taxable year, the

change in ownership will be reversed. If, at the end of one taxable year, the partnership cannot meet either section 4.01(1) or (3) of this revenue procedure for its current taxable year, then it must change to its required or permitted taxable year under section 4.01(1) of this revenue procedure.

.02 *Inapplicability*. This revenue procedure does not apply to:

(1) *Under examination*. A change or retention in annual accounting period if the partnership, S corporation, electing S corporation, or PSC is under examination, unless it obtains consent of the appropriate director as provided in section 7.03(1) of this revenue procedure;

(2) *Before an area office*. A change or retention in annual accounting period if the partnership, S corporation, electing S corporation, or PSC is before an area office with respect to any income tax issue and its annual accounting period is an issue under consideration by the area office;

(3) *Before a federal court*. A change or retention in annual accounting period if the partnership, S corporation, electing S corporation, or PSC is before a federal court with respect to any income tax issue and its annual accounting period is an issue under consideration by the federal court;

(4) *Partnerships and S corporations*. A change or retention in annual accounting period by a partnership or S corporation if, on the date the entity would otherwise file its application with the Service Center, the entity's annual accounting period is an issue under consideration in the examination of a partner's or shareholder's federal income tax return or an issue under consideration by an area office or by a federal court with respect to a partner's or shareholder's federal income tax return; or

(5) *Prior change*. A change to, or retention of, a natural business year as described in section 4.01(2) of this revenue procedure if the partnership, S corporation, electing S corporation, or PSC has changed its annual accounting period at any time within the most recent 48-month period ending with the last month of the requested taxable year. For this purpose, the following changes are not considered prior changes in annual accounting period:

(a) a change to a required taxable year or ownership taxable year;

(b) a change from a 52–53-week taxable year to a non-52–53-week taxable year that ends with reference to the same calendar month, and vice versa; or

(c) a change in accounting period by an S corporation, electing S corporation, or PSC, in order to comply with the common taxable year requirements of §§ 1.1502–75(d)(3)(v) and 1.1502–76(a)(1).

.03 *Nonautomatic Changes*. Any partnership, S corporation, electing S corporation, or PSC that wants to adopt, change to, or retain an annual accounting period that cannot do so automatically under this revenue procedure (because the requested taxable year is not described in section 4.01, or because of a prior change as described in section 4.02(5)) or pursuant to a provision in the Code, regulations, or other published administrative procedures, must obtain the approval of the Commissioner. *See* § 1.442–1(b) and Rev. Proc. 2002–39 for rules relating to nonautomatic changes of annual accounting periods by partnerships, S corporations, electing S corporations, and PSCs.

SECTION 5. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure:

.01 *Taxpayer*. The term "taxpayer" has the same meaning as the term "person" as defined in § 7701(a)(1) (*e.g.*, an individual, trust, estate, partnership, association, or corporation) rather than the meaning of the term "taxpayer" as defined in § 7701(a)(14) (any person subject to tax).

.02 *Electing S Corporations*. "Electing S corporations" are corporations attempting to make an S election for the short period described in section 5.09 of this revenue procedure. See Rev. Proc. 2002–37, 2002–22 I.R.B. 1030, superseding Rev. Proc. 2000–11, 2000–3 I.R.B. 309, for procedures for automatic approval to change an annual accounting period by corporations attempting to make an S election for the taxable year immediately following the short period.

.03 *Required Taxable Year*. The "required taxable year" is the taxable year determined under § 706(b) in the case of a partnership, § 1378 in the case of an S corporation or an electing S corporation, or § 441(i) in the case of a PSC, without taking into account any taxable year that is allowable by reason of a business purpose (including a grandfathered fiscal year) or a § 444 election.

.04 *Permitted Taxable Year*. A "permitted taxable year" is the required taxable year; a natural business year; the ownership taxable year; a taxable year elected under § 444; a 52–53-week taxable year that references the required taxable year, natural business year, ownership taxable year, or a taxable year elected under § 444; or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner.

.05 *Natural Business Year*. A partnership, S corporation, electing S corporation, or PSC establishes a "natural business year" under this revenue procedure by satisfying the following "25-percent gross receipts test":

(1) *Prior three years gross receipts*.

(a) Gross receipts from sales and services for the most recent 12-month period that ends with the last month of the requested annual accounting period are totaled and then divided into the amount of gross receipts from sales and services for the last 2 months of this 12-month period.

(b) The same computation as in (1)(a) above is made for the two preceding 12-month periods ending with the last month of the requested annual accounting period.

(2) *Natural business year*.

(a) Except as provided in (b) below, if each of the three results described in (1) equals or exceeds 25 percent, then the requested annual accounting period is deemed to be the taxpayer's natural business year.

(b) The taxpayer must determine whether any annual accounting period other than the requested annual accounting period also meets the 25-percent test described in (2)(a). If one or more other annual accounting periods produce higher averages of the three percentages (rounded to 1/100 of a percent) described in (1) than the requested annual accounting period, then the requested annual accounting period will not qualify as the taxpayer's natural business year.

(3) *Special rules*. (a) To apply the 25-percent gross receipts test for any particular year, the taxpayer must compute

its gross receipts under the method of accounting used to prepare its federal income tax returns for such taxable year.

(b) If a taxpayer has a predecessor organization and is continuing the same business as its predecessor, the taxpayer must use the gross receipts of its predecessor for purposes of computing the 25-percent gross receipts test.

(c) If the taxpayer (including any predecessor organization) does not have a 47-month period of gross receipts (36-month period for requested taxable year plus additional 11-month period for comparing requested taxable year with other potential taxable years), then it cannot establish a natural business year under this revenue procedure.

(d) If the requested taxable year is a 52–53-week taxable year, the calendar month ending nearest to the last day of the 52–53-week taxable year is treated as the last month of the requested taxable year for purposes of computing the 25-percent gross receipts test.

.06 *Ownership Taxable Year.* For an S corporation or electing S corporation, an "ownership taxable year" is the taxable year (if any) that, as of the first day of the first effective year, constitutes the taxable year of one or more shareholders (including any shareholder that concurrently changes to such taxable year) holding more than 50-percent of the corporation's issued and outstanding shares of stock. For this purpose, under principles similar to § 1.706–3T for determining the taxable year of a partnership, a shareholder that is tax-exempt under § 501(a) is disregarded if such shareholder is not subject to tax on any income attributable to the S corporation. Tax-exempt shareholders are not disregarded, however, if the S corporation is wholly-owned by such tax-exempt entities. A shareholder in an S corporation or electing S corporation that wants to concurrently change its taxable year must follow the instructions generally applicable to taxpayers changing their taxable years contained in § 1.442–1(b), Rev. Proc. 2002–39, or any other applicable administrative procedure published by the Commissioner.

.07 *Grandfathered Fiscal Year.* A grandfathered fiscal year is a fiscal year (other than a year that resulted in a three-month or less deferral of income) that a partnership or an S corporation received permission to use on or after July 1, 1974, by a letter ruling (*i.e.*, not by automatic approval).

.08 *First Effective Year.* The first effective year is the first taxable year for which an adoption, change, or retention in annual accounting period is effective. Thus, in the case of a change, the first effective year is the short period required to effect the change. The first effective year is also the first taxable year for complying with all the terms and conditions set forth in this revenue procedure necessary to effect the adoption, change, or retention in annual accounting period.

.09 *Short Period.* In the case of a change in annual accounting period, a taxpayer's short period is the period beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year.

.10 *Field Office, Area Office, Director.* The terms "field office," "area office," and "director" have the same meaning as those terms have in Rev. Proc. 2002–1, 2002–1 I.R.B. 1 (or any successor).

.11 *Under Examination.*

(1) *In general.*

(a) Except as provided in section 5.11(2) of this revenue procedure, an examination of a taxpayer with respect to a federal income tax return begins on the date the taxpayer is contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of the return. An examination ends:

(i) in a case in which the Service accepts the return as filed, on the date of the "no change" letter sent to the taxpayer;

(ii) in a fully agreed case, on the earliest of the date the taxpayer executes a waiver of restrictions on assessment or acceptance of overassessment (for example, Form 870, 4549, or 4605), the date the taxpayer makes a payment of tax that equals or exceeds the proposed deficiency, or the date of the "closing" letter (for example, Letter 891(IN) or 987(DO)) sent to the taxpayer; or

(iii) in an unagreed or a partially agreed case, on the earliest of the date the taxpayer (or its representative) is notified by an area officer that the case has been referred to an area office from a field office, the date the taxpayer files a petition in the Tax Court, the date on which the period for filing a petition with the Tax Court expires, or the date of the notice of claim disallowance.

(b) An examination does not end as a result of the early referral of an issue to an area office under the provisions of Rev. Proc. 96–9, 1996–1 C.B. 575, or Rev. Proc. 99–28, 1999–2 C.B. 109.

(c) An examination resumes on the date the taxpayer (or its representative) is notified by an appeals officer (or otherwise) that the case has been referred to a field office for reconsideration.

(2) *Partnerships and S corporations subject to TEFRA.* For an entity (including a limited liability company) treated as a partnership or S corporation that is subject to the TEFRA unified audit and litigation provisions (note that an S corporation is not subject to the TEFRA unified audit and litigation provisions for taxable years beginning after December 31, 1996, *see* Small Business Job Protection Act of 1996, Pub. L. No. 104–188, § 1317(a), 110 Stat. 1755, 1787 (1996)), an examination begins on the date that the notice of the beginning of an administrative proceeding is sent or personally delivered to the Tax Matters Partner/Tax Matters Person (TMP). An examination ends:

(a) in a case in which the Service accepts the partnership or S corporation return as filed, on the date of the "no adjustments" letter or the "no change" notice of final administrative adjustment sent to the TMP;

(b) in a case in which no formal notice is given, on the date on which the period under § 6229 expires;

(c) in a fully agreed case, when all the partners or shareholders execute a Form 870–P, 870–L, 870–S, or any variation thereof; or

(d) in an unagreed or a partially agreed case, on the earliest of the date the TMP (or its representative) is notified by an appeals officer that the case has been referred to an area office from a field office, the date the TMP (or a partner, member, or shareholder) requests judicial review, or the date on which the period for requesting judicial review expires.

.12 *Issue Under Consideration.*

(1) *During an examination.* A taxpayer's annual accounting period is an issue under consideration for the taxable years under examination if the taxpayer

receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining agent(s) specifically citing the taxpayer's annual accounting period as an issue under consideration. For example, a taxpayer's annual accounting period is an issue under consideration as a result of an examination plan that identifies the propriety of the taxpayer's annual accounting period as a matter to be examined. The question of whether the taxpayer's annual accounting period is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2002–2, 2002–1 I.R.B. 82 (or any successor).

(2) *Before an area office*. A taxpayer's annual accounting period is an issue under consideration for the taxable years before an area office if the taxpayer's annual accounting period is included as an item of adjustment in the examination report referred to the area office or is specifically identified in writing to the taxpayer by the area office.

(3) *Before a federal court*. A taxpayer's annual accounting period is an issue under consideration for the taxable years before a federal court if the taxpayer's annual accounting period is an item included in the statutory notice of deficiency, the notice of claim disallowance, the notice of final administrative adjustment, the pleadings (for example, the petition, complaint, or answer) or amendments thereto, or is specifically identified in writing to the taxpayer by the government counsel.

.13 *Personal Service Corporation*. For purposes of this revenue procedure, a PSC does not include a corporation that has a required taxable year under a provision of the Code other than § 441(i) (*e.g.*, a specified foreign corporation as defined in § 898(b)(1)).

SECTION 6. TERMS AND CONDITIONS

.01 *In General*. An adoption, change, or retention in annual accounting period filed under this revenue procedure must be made pursuant to the terms and conditions provided in this revenue procedure.

.02 *Short Period Tax Return*. The taxpayer generally must file a federal income tax return for the short period required to effect a change by the due date of that return, including extensions, in accordance with § 1.443–1(a). In the case of a PSC, the corporation's taxable income for the short period must be annualized and the tax must be computed in accordance with the provisions of § 443(b) and § 1.443–1(b). However, for changes to (or from) a 52–53-week taxable year referencing the same month as the current (or requested) taxable year, see special rules in § 1.441–2.

.03 *Subsequent Year Tax Returns*. Returns for subsequent taxable years generally must be made on the basis of a full 12 months (or on a 52–53-week basis) ending on the last day of the requested taxable year, unless the taxpayer secures the approval of the Commissioner to change that taxable year.

.04 *Record Keeping/Book Conformity*. The books of the taxpayer must be closed as of the last day of the first effective year. Thereafter, the taxpayer must compute its income and keep its books and records (including financial statements and reports to creditors) on the basis of the requested taxable year, except that this requirement shall not apply (1) to books and records maintained solely for foreign law purposes (*e.g.*, foreign tax reporting purposes), or (2) if the requested taxable year is either the taxpayer's required taxable year or ownership taxable year.

.05 *Changes in Natural Business Year*. If a partnership, S corporation, electing S corporation, or PSC changes to or retains a natural business year under this revenue procedure and that year no longer qualifies as a permitted taxable year, the taxpayer is using an impermissible annual accounting period and should change to a permitted taxable year. Taxpayers qualifying under section 4 of this revenue procedure may request automatic approval for the change under the provisions of this revenue procedure. Other taxpayers must request approval under Rev. Proc. 2002–39.

.06 *Changes in Ownership Taxable Year*. An S corporation or electing S corporation that adopts, changes to, or retains an ownership taxable year under this revenue procedure must change to a permitted taxable year, or request approval to retain its current taxable year, if, as of the first day of any taxable year, its ownership taxable year changes. S corporations qualifying under section 4 of this revenue procedure may request automatic approval for the change or retention under the provisions of this revenue procedure. Other taxpayers must request approval under Rev. Proc. 2002–39.

.07 *52–53-week Taxable Years*. If applicable, the taxpayer must comply with § 1.441–2(e) (relating to the timing of taking items into account in those cases where the taxable year of a pass-through entity or PSC ends with reference to the same calendar month as one or more of its partners, shareholders, or employee-owners).

.08 *Creation of Net Operating Loss or Capital Loss*. In the case of a PSC changing to a natural business year, if the PSC generates a net operating loss (NOL) or capital loss (CL) in the short period required to effect the change in annual accounting period, the PSC may not carry the NOL or CL back, but must carry it over in accordance with the provisions of §§ 172 and 1212, respectively, beginning with the first taxable year after the short period. However, except as provided in § 280H and the regulations thereunder, the short period NOL or CL is carried back or carried over in accordance with §§ 172 or 1212, respectively, if it is either (a) $50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL or CL for a full 12-month period beginning with the first day of the short period.

.09 *Creation of General Business Credits*. In the case of a PSC changing to a natural business year, if there is an unused general business credit or any other unused credit generated in the short period, the PSC must carry that unused credit forward. An unused credit from the short period may not be carried back.

SECTION 7. GENERAL APPLICATION PROCEDURES

.01 *Approval*. Approval is hereby granted to any partnership, S corporation, electing S corporation, or PSC within the scope of this revenue procedure to adopt, change, or retain its annual accounting period, provided the taxpayer complies with all the applicable provisions of this

revenue procedure. Approval is granted beginning with the first effective year. A partnership, S corporation, electing S corporation, or PSC granted approval under this revenue procedure to adopt, change to, or retain an annual accounting period other than its required year is deemed to have established a business purpose for the adoption, change, or retention to the satisfaction of the Commissioner.

.02 *Filing Requirements*.

(1) *Where to file*. A taxpayer within the scope of this revenue procedure that wants to adopt, change, or retain its annual accounting period under this revenue procedure must complete and file an application (*i.e.*, a current Form 1128 or Form 2553, *Election by a Small Business Corporation*, in the case of an electing S corporation) with the Director, Internal Revenue Service Center, Attention: ENTITY CONTROL, where the taxpayer files its federal income tax return. No copies of Form 1128 (or Form 2553) are required to be sent to the national office. The taxpayer also must attach a copy of the Form 1128 (or Form 2553) to the federal income tax return filed for the first effective year.

(2) *When to file*. The Form 1128 must be filed no earlier than the day following the end of the first effective year and no later than the due date (including extensions) for filing the federal income tax return for the first effective year. For electing S corporations, the Form 2553 must be filed when the election to be an S corporation is filed pursuant to § 1362(b) and § 1.1362–6. Generally, such election must be filed at any time during (a) the taxable year that immediately precedes the taxable year for which the election is to be effective, or (b) the taxable year for which the election is to be effective, provided the election is made before the 16th day of the third month of the taxable year.

(3) *Label*. In order to assist in the processing of the adoption, change, or retention in annual accounting period, taxpayers should write at the top of page 1 of the Form 1128 (Form 2553): "FILED UNDER REV. PROC. 2002–38."

(4) *Signature requirements*. In the case of a partnership, the Form 1128 must be signed on behalf of the partnership by a general partner. In the case of a limited liability company that elects to be treated as a partnership, the Form 1128 must be signed by a member-manager who has personal knowledge of the facts. In all other cases, the Form 1128 (Form 2553) must be signed by an authorized corporate officer. If an agent is authorized to represent the taxpayer before the Service, to receive the original or a copy of correspondence concerning the application, or to perform any other act(s) regarding the application on behalf of the taxpayer, a power of attorney reflecting such authorization(s) should be attached to the application. A taxpayer's representative without a power of attorney to represent the taxpayer will not be given any information about the application.

(5) *No user fee*. A user fee is not required for applications filed under this revenue procedure and, except as provided in section 9.01 of this revenue procedure, the receipt of an application filed under this revenue procedure may not be acknowledged.

(6) *Additional information*. In the case of a taxpayer changing to a natural business year that satisfies the 25-percent gross receipts test described in section 5.05 of this revenue procedure, the taxpayer must supply the gross receipts for the most recent 47 months for itself (or any predecessor) in compliance with the instructions to Form 1128 (or Form 2553).

.03 *Additional Procedures If Under Examination, Before an Area Office, or Before a Federal Court*.

(1) *Taxpayers under examination*.

(a) A taxpayer under examination may request approval to change or retain its annual accounting period under this revenue procedure only if the appropriate director consents to the change or retention. The director will consent to the change or retention unless, in the opinion of the director, the taxpayer's annual accounting period ordinarily would be included as an item of adjustment in the year(s) for which the taxpayer is under examination. For example, the director will consent to a change where the taxpayer is using a permissible annual accounting period. The director also will consent to a change from an impermissible annual accounting period where the period became impermissible (*e.g.*, due to a change in ownership or a change in the taxpayer's business) subsequent to the years under examination. The question of whether the taxpayer's annual accounting period from which the taxpayer is changing is permissible or became impermissible subsequent to the years under examination may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2002–2.

(b) A taxpayer changing or retaining an annual accounting period under this revenue procedure with the consent of the appropriate director must attach to the application a statement from the director consenting to the change or retention. The taxpayer must provide a copy of the application to the director at the same time it files the application with the Service Center. The application must contain the name(s) and telephone number(s) of the examining agent(s).

(2) *Taxpayers before an area office*. A taxpayer that is before an area office must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the taxpayer's annual accounting period is not an issue under consideration by the area office. The taxpayer must provide a copy of the application to the appeals officer at the same time it files the application with the Service Center. The application must contain the name and telephone number of the appeals officer.

(3) *Taxpayers before a federal court*. A taxpayer that is before a federal court must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the taxpayer's annual accounting period is not an issue under consideration by the federal court. The taxpayer must provide a copy of the application to the government counsel at the same time it files the application with the Service Center. The application must contain the name and telephone number of the government counsel.

SECTION 8. EFFECT OF APPROVAL

.01 *Audit Protection*.

(1) *In general*. Except as provided in section 8.01(2) of this revenue procedure, a taxpayer that files an application in compliance with all the applicable provisions of this revenue procedure will not be required by the Service to change its

annual accounting period for a taxable year prior to the first effective year.

(2) *Exceptions*. The Service may change a taxpayer's annual accounting period for a prior taxable year if:

(a) the taxpayer fails to implement the change;

(b) the taxpayer implements the change but does not comply with all the applicable provisions of this revenue procedure; or

(c) there was a misstatement or omission of material facts.

.02 *Subsequently Required Changes*.

(1) *In general*. A taxpayer that adopts, changes, or retains its annual accounting period pursuant to this revenue procedure may be required to subsequently change its annual accounting period for the following reasons:

(a) the enactment of legislation;

(b) a decision of the United States Supreme Court;

(c) the issuance of temporary or final regulations;

(d) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin;

(e) the issuance of written notice to the taxpayer that the change in annual accounting period was not in compliance with all the applicable provisions of this revenue procedure or is not in accord with the current view of the Service; or

(f) a change in the material facts on which the approval was granted.

(2) *Retroactive change*. Except in rare circumstances, if a taxpayer that adopts, changes, or retains its annual accounting period under this revenue procedure is subsequently required under section 8.02(1) of this revenue procedure to change that annual accounting period, the required change will not be applied retroactively, provided that:

(a) the taxpayer complied with the applicable provisions of this revenue procedure;

(b) there has been no misstatement or omission of material facts;

(c) there has been no change in the material facts on which the approval was based;

(d) there has been no change in the applicable law; and

(e) the taxpayer to which the approval was granted acted in good faith in relying on the approval, and applying the change retroactively would be to the taxpayer's detriment.

SECTION 9. REVIEW OF APPLICATION

.01 *Service Center Review*. A Service Center may deny an adoption, change, or retention of an annual accounting period under this revenue procedure only if (1) the Form 1128 (or Form 2553) is not filed timely, or (2) the taxpayer fails to meet the scope or any term and condition of this revenue procedure. If the application is denied, the Service Center will return the application with an explanation for the denial. In the case of a denial of an accounting period request filed on Form 2553, the corporation will be required to use the calendar year or, if applicable, make a § 444 election, if it chooses to be an S corporation.

.02 *Review of Director*. The appropriate director may ascertain if the adoption, change, or retention of annual accounting period was made in compliance with all the applicable provisions of this revenue procedure. Taxpayers adopting, changing, or retaining their annual accounting period pursuant to this revenue procedure without complying with all the provisions (including the terms and conditions) of this revenue procedure ordinarily will be deemed to have initiated the adoption, change, or retention of annual accounting period without the approval of the Commissioner. Upon examination, a taxpayer that has initiated an unauthorized adoption, change, or retention of annual accounting period may be denied the adoption, change, or retention. For example, the taxpayer may be required to recompute its taxable income or loss in accordance with its former (or required, if applicable) taxable year.

SECTION 10. EFFECTIVE DATE AND TRANSITION RULE

.01 *Effective Date*. This revenue procedure generally is effective for adoptions, changes, or retentions of annual accounting periods for which the first effective year ends on or after May 10, 2002. However, if the time period for filing Form 1128 (or Form 2553) with respect to a taxable year set forth in section 7.02(2) of this revenue procedure has not yet expired, a taxpayer within the scope of this revenue procedure may elect early application of the revenue procedure by providing the notification set forth in section 7.02(3) on the top of page 1 of Form 1128 (or Form 2553) and by satisfying the other procedural requirements of section 7.

.02 *Transition Rule*. If a taxpayer within the scope of this revenue procedure filed an application with the national office and the application is pending with the national office on May 10, 2002, the taxpayer may obtain approval under this revenue procedure. However, the national office will process the application in accordance with the authority under which it was filed, unless by the later of June 25, 2002, or the issuance of the letter ruling granting or denying approval for the adoption, change, or retention, the taxpayer notifies the national office that it wants to use this revenue procedure. If the taxpayer timely notifies the national office that it wants to use this revenue procedure, the national office will require the taxpayer to make appropriate modifications to the application to comply with the applicable provisions of this revenue procedure. In addition, any user fee that was submitted with the application will be refunded to the taxpayer.

SECTION 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 87–32 is clarified, modified, amplified, and superseded.

SECTION 12. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1786. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are found in sections 7 and 10. The information in section 7 is required in order to determine whether the taxpayer properly obtained automatic

approval to adopt, change, or retain its annual accounting period. The information in section 10 is required in order to allow a taxpayer to apply the provisions of this revenue procedure to a pending application. The likely respondents are the following: partnerships, S corporations, electing S corporations, and PSCs.

The estimated total annual reporting burden for the requirements contained in section 7 of this revenue procedure is reflected in the burden estimates for Forms 1128 and 2553. The estimated total annual reporting burden for the requirement contained in section 10 of this revenue procedure is 50 hours: the estimated annual burden per respondent is 30 minutes; the estimated number of respondents is 100; and the estimated annual frequency of response is once.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Michael F. Schmit and Roy A. Hirschhorn of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Schmit or Mr. Hirschhorn at (202) 622–4960 (not a toll-free call).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 441, 442, 444, 706, 1378, 1502; 1.441–1, 1.441–3, 1.442–1, 1.706–1, 1.1378–1, 1.1502–76.)

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SECTION 1. PURPOSE

This revenue procedure provides the general procedures under § 442 of the Internal Revenue Code and § 1.442–1(b) of the Income Tax Regulations for establishing a business purpose and obtaining the approval of the Commissioner of Internal Revenue to adopt, change, or retain an annual accounting period for federal income tax purposes. This revenue procedure also describes the terms, conditions, and adjustments that the Commissioner may deem necessary to effect the adoption, change, or retention.

SECTION 2. BACKGROUND

.01 *Taxable Year Defined.*

(1) *In general.* Section 441(b) and § 1.441–1(b)(1) provide that the term "taxable year" generally means the taxpayer's annual accounting period, if it is a calendar or fiscal year, or, if applicable, the taxpayer's required taxable year.

(2) *Annual accounting period.* Section 441(c) and § 1.441–1(b)(3) provide that the term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

(3) *Required taxable year.* Section 1.441–1(b)(2) provides that certain taxpayers must use the particular taxable year that is required under the Code and the regulations thereunder. For example, a partnership, S corporation, or personal service corporation (PSC) has a required taxable year that generally conforms to the taxable years of its partners, shareholders, or employee-owners pursuant to §§ 706(b), 1378, and 441(i), respectively. Similarly, a specified foreign corporation has a required taxable year that generally represents the taxable year of its majority U.S. shareholder pursuant to § 898. However, § 1.441–1(b)(2)(ii) describes exceptions under which certain taxpayers may use a taxable year other than their required taxable year. For example, a partnership, S corporation, electing S corporation, or PSC may have a taxable year other than its required taxable year if it makes an election under § 444, elects to use a 52–53-week taxable year that references its required taxable year or a taxable year elected under § 444, or establishes a business purpose and obtains approval under § 442 for that taxable year. *See also* §§ 706(b), 1378, and 441(i).

.02 *Adoption of Taxable Year.* Generally, a taxpayer may adopt any taxable year that satisfies § 441 and the regulations thereunder without the approval of the Commissioner. However, a partnership, electing S corporation, or PSC that wants to adopt a taxable year other than its required taxable year, a taxable year elected under § 444, or a 52–53-week taxable year that references its required taxable year or a taxable year elected under § 444 must establish a business purpose and obtain approval under § 442. *See* § 1.441–1(c).

.03 *Change in Taxable Year.*

(1) *In general.* Section 1.442–1(a)(1) generally provides that a taxpayer that wants to change its annual accounting period and use a new taxable year must obtain approval of the Commissioner.

(2) *Annualization of short period return.* Section 443(b) and § 1.443–1(b)(1)(i) provide that if a return is made for a short period resulting from a change of an annual accounting period, the taxable income for the short period must be placed on an annual basis by multiplying the income by 12 and dividing the result by the number of months in the short period. Unless § 443(b)(2) and § 1.443–1(b)(2) apply, the tax for the short period generally is the same part of the tax computed on an annual basis as the number of months in the short period is of 12 months. But see, for example, §§ 1.706–1(b)(8)(i)(B), 1.852–3(e), 1.857–2(a)(4), 1.1378–1(c)(2), and 1.1502–76 for exceptions to this general rule for a partnership, a regulated investment company (RIC), a real estate investment trust (REIT), an S corporation, and a subsidiary ceasing to be a member of a consolidated group, respectively.

(3) *No retroactive change in annual accounting period.* Unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in annual accounting period, regardless of whether the change is to a required taxable year.

.04 *Retention of Taxable Year.* In certain cases, a partnership, S corporation, electing S corporation, or PSC will be required to change its taxable year unless it establishes a business purpose and obtains the approval of the Commissioner under § 442, or makes an election under § 444, to retain its current taxable year. *See* § 1.441–1(d). For example, a corporation using a June 30 fiscal year that either becomes a PSC or elects to be an S corporation, and as a result is required to use the calendar year, must obtain the approval of the Commissioner to retain its current fiscal year. Similarly, a partnership using a taxable year that corresponds

to its required taxable year generally must obtain the approval of the Commissioner to retain that taxable year if its required taxable year changes as a result of a change in ownership. *But see* § 706(b)(4)(B). However, a partnership that has previously established a business purpose to the satisfaction of the Commissioner to use a particular fiscal year is not required to obtain the approval of the Commissioner to retain such fiscal year if its required taxable year changes.

.05 *Approval of an Adoption, Change, or Retention.*

(1) *In general.* Section 1.442–1(b) provides that in order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128, *Application to Adopt, Change, or Retain a Tax Year,* with the Commissioner within such time and in such manner as is provided in administrative procedures published by the Commissioner. In general, an adoption, change, or retention in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention.

(2) *Automatic approval.* Under the Code and regulations, certain taxpayers are allowed to change their annual accounting periods without approval or with automatic approval (*see, e.g.*, §§ 444, 859(b), and § 1.442–1(c) and (d)). In addition, the Service has issued revenue procedures that enable certain taxpayers to obtain automatic approval to adopt, change, or retain their annual accounting periods. *See*, for example, Rev. Proc. 2002–37, 2002–22 I.R.B. 1030 (or any successor) for corporations; Rev. Proc. 2002–38, 2002–22 I.R.B. 1037 (or any successor) for partnerships, S corporations, electing S corporations, and PSCs; and Rev. Proc. 66–50, 1966–2 C.B. 1260 (or any successor) for individuals.

.06 *Business Purpose.*

(1) *In general.* Section 1.442–1(b) provides that in determining whether a taxpayer has established a business purpose and which terms, conditions, and adjustments will be required, consideration will be given to all the facts and circumstances relating to the adoption, change, or retention, including the tax consequences resulting therefrom. *See also* H.R. Rep. No. 99–841, 99th Cong., 2d Sess., II–318, 1986–3 (Vol. 4) C.B. 319.

(2) *Sufficient business purposes.* Section 1.442–1(b)(2) provides that generally the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's required taxable year, ownership taxable year, or natural business year. A taxpayer generally is deemed to have established a natural business year if it satisfies the "25-percent gross receipts test." *See* Rev. Proc. 83–25, 1983–1 C.B. 689, superseded by Rev. Proc. 87–32, 1987–2 C.B. 396, superseded by Rev. Proc. 2002–38, 2002–22 I.R.B. 1037. In Rev. Rul. 87–57, 1987–2 C.B. 117, the Service determined that a partnership, S corporation, or PSC established, to the satisfaction of the Secretary, a business purpose for adopting, retaining, or changing its taxable year in the following four situations:

(a) the taxpayer established that the taxable year satisfied the 25-percent gross receipts test and resulted in less deferral than its other natural business year;

(b) the taxpayer would have established a natural business year under the 25-percent gross receipts test, except that a labor strike closed the taxpayer's business during a period that included its normal peak season;

(c) the taxpayer, for the past 10 years, had a three-month period of insignificant gross receipts during which, due to weather conditions, its business was not operational; and

(d) the taxpayer, which previously used the cash receipts and disbursements method and changed to an accrual method, would have established a natural business year under the 25-percent gross receipts test if it had calculated its gross receipts under an accrual method.

(3) *Insufficient business purposes.* Section 1.442–1(b) provides that, in the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners will not be treated as a business purpose for using a taxable year other than its required taxable year. In addition, the legislative history to the Tax Reform Act of 1986 provides that the following reasons ordinarily will not be sufficient for a partnership, S corporation, or PSC to establish that the business purpose requirement for a particular taxable year has been met:

(a) the use of a particular year for regulatory or financial accounting purposes;

(b) the hiring patterns of a particular business, *e.g.*, the fact that a firm typically hires staff during certain times of the year;

(c) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and

(d) the fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis.

Although the above items are not themselves sufficient to establish a business purpose, they may be considered in connection with other items by the Commissioner in determining whether a taxpayer has a business purpose for a particular taxable year. H.R. Rep. No. 99–841, 99th Cong., 2d Sess., II–318, 1986–3 (Vol. 4) C.B. 319

.07 *Section 444 Elections.* A partnership, S corporation, electing S corporation, or PSC generally can elect under § 444 to use a taxable year other than its required taxable year, but only if the deferral period of the taxable year elected is not longer than the shorter of 3 months or the deferral period of the taxable year being changed. A partnership and an S corporation with a § 444 election must make required payments under § 7519 that approximate the amount of the deferral benefit and a PSC with a § 444 election is subject to the minimum distribution requirements of § 280H. A taxpayer may automatically adopt, change to, or retain a taxable year permitted by § 444 by filing a Form 8716, *Election to Have a Taxable Year Other Than a Required Taxable Year.* A taxpayer that wants to terminate its § 444 election must follow the automatic procedures under § 1.444–

1T(a)(5) to change to its required taxable year or establish a business purpose for using a different taxable year pursuant to § 442, the regulations thereunder, and Rev. Proc. 2002–38 or this revenue procedure (whichever is applicable).

SECTION 3. SCOPE

.01 *Applicability*. Except as provided in section 3.02 of this revenue procedure, this revenue procedure applies to any taxpayer requesting the Commissioner's approval to adopt, change, or retain an annual accounting period for federal income tax purposes.

.02 *Inapplicability*. This revenue procedure does not apply to:

(1) *Automatic approval*. An adoption, change, or retention of annual accounting period that is permitted to be made pursuant to a provision of the Code or regulations or a published automatic approval procedure. Before submitting an application pursuant to this revenue procedure, taxpayers are encouraged to review the automatic approval procedures referenced in § 1.442–1 and the following revenue procedures: Rev. Proc. 2002–37 (for corporations); Rev. Proc. 2002–38 (for partnerships, S corporations, electing S corporations, and PSCs); Rev. Proc. 66–50, as modified by Rev. Proc. 81–40, 1981–2 C.B. 604 (for individuals); Rev. Proc. 85–58, 1985–2 C.B. 740, and Rev. Proc. 76–10, 1976–1 C.B. 548, as modified by Rev. Proc. 79–3, 1979–1 C.B. 483 (for exempt organizations); Rev. Proc. 87–27, 1987–1 C.B. 769 (for employee retirement plans and employee trusts); and Rev. Proc. 85–15, 1985–1 C.B. 516 (for changes to comply with § 441(g)).

(2) *Under examination*. A taxpayer with a required taxable year that is under examination, unless the taxpayer obtains the consent of the appropriate director as provided in section 6.06(1) of this revenue procedure.

(3) *Before an area office*. A taxpayer with a required taxable year that is before an area office with respect to any income tax issue if its annual accounting period is an issue under consideration by the area office.

(4) *Before a federal court*. A taxpayer with a required taxable year that is before a federal court with respect to any income tax issue if its annual accounting period is an issue under consideration by the federal court.

(5) *Partnerships and S corporations*. A partnership or S corporation if, on the date the entity would otherwise file its application with the Service Center, the entity's annual accounting period is an issue under consideration in the examination of a partner's or shareholder's federal income tax return or an issue under consideration by an area office or by a federal court with respect to a partner's or shareholder's federal income tax return.

SECTION 4. DEFINITIONS

.01 *Taxpayer*. The term "taxpayer" has the same meaning as the term "person" as defined in § 7701(a)(1) (*e.g.*, an individual, trust, estate, partnership, association, or corporation) rather than the meaning of the term "taxpayer" as defined in § 7701(a)(14) (any person subject to tax).

.02 *Corporation*. The term "corporation" includes each member of a consolidated group. However, the common parent of a consolidated group may change the group's annual accounting period under this revenue procedure if every member of the consolidated group meets all the requirements and complies with all the conditions of this revenue procedure.

.03 *Pass-through Entity*. For purposes of this revenue procedure, the term "pass-through entity" means a partnership; an S corporation (as defined in § 1361); an electing S corporation (*i.e.*, a corporation attempting to make an S election for the first effective year); a trust; an estate; a common trust fund (as defined in § 584); a controlled foreign corporation (CFC) (as defined in § 957), but only to the extent the taxpayer is a U.S. shareholder (as defined in § 951(b)); a foreign personal holding company (FPHC) (as defined in § 552), but only to the extent the taxpayer is a U.S. shareholder (as defined in § 551(a)); a passive foreign investment company (PFIC), but only to the extent the taxpayer has elected to treat the PFIC as a qualified electing fund (as defined in § 1295); a closely-held REIT (as defined in § 6655(e)(5)(B)), but only if the taxpayer is described in § 6655(e)(5)(A)); or any other similar entity.

.04 *Required Taxable Year*. The "required taxable year" is the particular taxable year that certain taxpayers are required to use under the Code or regulations thereunder. For example, the "required taxable year" is the taxable year determined under § 706(b) in the case of a partnership, § 1378 in the case of an S corporation or an electing S corporation, and § 441(i) in the case of a PSC, without taking into account any taxable year that is allowable by reason of a § 444 election. *See generally* § 1.441–1(b)(2) (providing examples of other entities with required taxable years).

.05 *Permitted Taxable Year*. The term "permitted taxable year" means the required taxable year; a natural business year; the ownership taxable year; a taxable year elected under § 444; a 52–53-week taxable year that references the required taxable year, natural business year, ownership taxable year, or taxable year elected under § 444; or any other taxable year for which the taxpayer establishes a business purpose to the satisfaction of the Commissioner.

.06 *First Effective Year*. The first effective year is the first taxable year for which an adoption, change, or retention in annual accounting period is effective. Thus, in the case of a change, the first effective year is the short period required to effect the change. The first effective year is also the first taxable year for complying with all the terms and conditions set forth in the letter ruling granting permission to effect the adoption, change, or retention of the taxpayer's annual accounting period.

.07 *Short Period*. In the case of a change in annual accounting period, a taxpayer's short period is the period beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year.

.08 *Field Office, Area Office, Director*. The terms "field office," "area office," and "director" have the same meaning as those terms have in Rev. Proc. 2002–1, 2002–1 I.R.B. 1 (or any successor).

.09 *Under Examination*.

(1) *In general*.

(a) Except as provided in section 4.08(2) of this revenue procedure, an examination of a taxpayer with respect to a federal income tax return begins on the date the taxpayer is contacted in any manner by a representative of the Service for

the purpose of scheduling any type of examination of the return. An examination ends:

(i) in a case in which the Service accepts the return as filed, on the date of the "no change" letter sent to the taxpayer;

(ii) in a fully agreed case, on the earliest of the date the taxpayer executes a waiver of restrictions on assessment or acceptance of overassessment (for example, a Form 870, 4549, or 4605), the date the taxpayer makes a payment of tax that equals or exceeds the proposed deficiency, or the date of the "closing" letter (for example, Letter 891(IN) or 987(DO)) sent to the taxpayer; or

(iii) in an unagreed or a partially agreed case, on the earliest of the date the taxpayer (or its representative) is notified by an appeals officer that the case has been referred to an area office from a field office, the date the taxpayer files a petition in the Tax Court, the date on which the period for filing a petition with the Tax Court expires, or the date of the notice of claim disallowance.

(b) An examination does not end as a result of the early referral of an issue to an area office under the provisions of Rev. Proc. 96–9, 1996–1 C.B. 575, or Rev. Proc. 99–28, 1999–2 C.B. 109.

(c) An examination resumes on the date the taxpayer (or its representative) is notified by an appeals officer (or otherwise) that the case has been referred to a field office for reconsideration.

(2) *Partnerships and S corporations subject to TEFRA*. For an entity (including a limited liability company) treated as a partnership or an S corporation that is subject to the TEFRA unified audit and litigation provisions (note that an S corporation is not subject to the TEFRA unified audit and litigation provisions for taxable years beginning after December 31, 1996, *see* Small Business Job Protection Act of 1996, Pub. L. No. 104–188, § 1317(a), 110 Stat. 1755, 1787 (1996)), an examination begins on the date of the notice of the beginning of an administrative proceeding sent or personally delivered to the Tax Matters Partner/Tax Matters Person (TMP). An examination ends:

(a) in the case in which the Service accepts the partnership or S corporation return as filed, on the date of the "no adjustments" letter or the "no change" notice of the final administrative adjustment sent to the TMP;

(b) in a case in which no formal notice is given, on the date on which the period under § 6229 expires;

(c) in a fully agreed case, when all the partners or shareholders execute a Form 870–P, 870–L, 870–S, or any variation thereof; or

(d) in an unagreed or a partially agreed case, on the earliest of the date the TMP (or its representative) is notified by an appeals officer that the case has been referred to an area office from a field office, the date the TMP (or a partner or shareholder) requests judicial review, or the date on which the period for requesting judicial review expires.

.10 *Issue Under Consideration*.

(1) *During an examination*. A taxpayer's annual accounting period is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining officer(s) specifically citing the taxpayer's annual accounting period as an issue under consideration. For example, a taxpayer's annual accounting period is an issue under consideration as a result of an examination plan that identifies the propriety of the taxpayer's annual accounting period as a matter to be examined. The question of whether the taxpayer's annual accounting period is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2002–2, 2002–1 I.R.B. 82 (or any successor), or, for exempt organizations, Rev. Proc. 2002–5, 2002–1 I.R.B. 173 (or any successor).

(2) *Before an area office*. A taxpayer's annual accounting period is an issue under consideration for the taxable years before an area office if the taxpayer's annual accounting period is included as an item of adjustment in the examination report referred to an area office or is specifically identified in writing to the taxpayer by an area office.

(3) *Before a federal court*. A taxpayer's annual accounting period is an issue under consideration for the taxable years before a federal court if the taxpayer's annual accounting period is an item included in the statutory notice of deficiency, the notice of claim disallowance, the notice of final administrative adjustment, the pleadings (for example, the petition, complaint, or answer) or amendments thereto, or is specifically identified in writing to the taxpayer by the government counsel.

SECTION 5. BUSINESS PURPOSE AND TERMS, CONDITIONS, AND ADJUSTMENTS

.01 *In General*.

(1) *Approval of requests*. Except as provided in section 5.01(2) of this revenue procedure, a request to adopt, change, or retain an annual accounting period ordinarily will be approved if the taxpayer:

(a) establishes a business purpose (within the meaning of section 5.02 of this revenue procedure) for the requested annual accounting period; and

(b) agrees to the Commissioner's prescribed terms, conditions, and adjustments (as described in sections 5.04 and 5.05 of this revenue procedure) under which the adoption, change, or retention will be effected.

(2) *Exceptions*. Notwithstanding the general rule of section 5.01(1)(a) of this revenue procedure, a taxpayer with a required taxable year (other than a partnership, S corporation, electing S corporation, or PSC) will not be granted approval under this revenue procedure to adopt, change, or retain a taxable year other than its required taxable year or, in appropriate circumstances, a 52–53-week taxable year that ends with reference to its required taxable year. In addition, a partnership, S corporation, electing S corporation, or PSC will be granted approval to adopt, change, or retain an annual accounting period only if it establishes a business purpose under section 5.02(1) for that annual accounting period. Notwithstanding the general rule of section 5.01(1)(b) of this revenue procedure, the Service may determine that, based on the unique facts of a particular case and in the interest of sound tax administration, terms, conditions, and adjustments that differ from those provided in this revenue procedure are more appropriate for an adoption, change, or retention made under this revenue procedure.

.02 *Business Purpose.*

(1) *Taxpayers that establish a business purpose.* Taxpayers that establish a business purpose for the requested annual accounting period under this section 5.02(1) ordinarily will be granted approval to adopt, change, or retain that annual accounting period under this revenue procedure subject only to the general terms and conditions described in section 5.04 of this revenue procedure.

(a) *Natural business year.* A taxpayer (including a partnership, S corporation, electing S corporation, or PSC) requesting to adopt, change, or retain an annual accounting period that is the taxpayer's natural business year (as described in section 5.03 of this revenue procedure) has established a business purpose to the satisfaction of the Commissioner.

(b) *Facts and circumstances.* A taxpayer (including a partnership, S corporation, electing S corporation, or PSC) may establish a business purpose for the requested taxable year based on all the relevant facts and circumstances. However, the Service anticipates that a taxpayer will be granted permission to adopt, change, or retain an annual accounting period under this facts and circumstances test only in rare and unusual circumstances. For this purpose, deferral of income to owners will not be treated as a business purpose. In addition, administrative and convenience business reasons such as those described in Rev. Rul. 87–57 and the following will not be sufficient to establish a business purpose under this section:

(i) the use of a particular year for regulatory or financial accounting purposes;

(ii) the hiring patterns of a particular business, *e.g.*, the fact that a firm typically hires staff during certain times of the year;

(iii) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders;

(iv) the fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis;

(v) the use of a particular year by related entities; and

(vi) the use of a particular year by competitors.

(2) *Taxpayers that are deemed to have established a business purpose.* A taxpayer other than a partnership, S corporation, electing S corporation, or PSC that does not establish a business purpose for the requested annual accounting period under section 5.02(1) of this revenue procedure generally will be deemed to have established a business purpose if it provides a non-tax reason for the requested annual accounting period and agrees to the additional terms, conditions, and adjustments described in section 5.05 of this revenue procedure, which are intended to neutralize the tax effects of any resulting substantial distortion of income. For this purpose, non-tax reasons for the requested annual accounting period may include administrative and convenience business reasons such as those described in section 5.02(1)(b) that Congress intended, and the Service has held, to be insufficient to satisfy the business purpose requirement for a partnership, S corporation, electing S corporation, or PSC to adopt, change to, or retain a taxable year other than its required taxable year. The Service anticipates that an individual taxpayer that is not a sole proprietor will be able to establish a non-tax reason for a fiscal year only in rare and unusual circumstances.

.03 *Natural Business Year.* A natural business year is the annual accounting period encompassing all related income and expenses. The natural business year of a taxpayer may be determined under any of the following tests (taking into account the principles of Rev. Rul. 87–57):

(1) *Annual business cycle test.*

(a) *In general.* If the taxpayer's gross receipts from sales and services for the short period and the three immediately preceding taxable years indicate that the taxpayer has a peak and a non-peak period of business, the taxpayer's natural business year is deemed to end at, or soon after, the close of the highest peak period of business. A business whose income is steady from month to month throughout the year will not satisfy this test. A taxpayer that has not been in existence for a sufficient period to provide gross receipts information for the three immediately preceding taxable years may provide information other than gross receipts to demonstrate a peak and non-peak period of business, such as a description of its business and/or reasonable estimates of future gross receipts.

(b) *Safe harbor.* For purposes of section 5.03(1)(a) of this revenue procedure, 1 month will be deemed to be "soon after" the close of the highest peak period of business.

(c) *Example.* A, a corporation, operates a retail business. The highest peak of A's annual business cycle occurs in December each year. In January, a significant amount of the merchandise that was purchased by A's customers in December is either returned or exchanged. A's natural business year is deemed to end at (December 31st), or soon after (January 31st), the close of the highest peak period of business in December. Accordingly, under the provisions of this revenue procedure, a request by A for a taxable year ending either December 31st or January 31st would be granted, subject to the general terms and conditions of section 5.04 of this revenue procedure.

(2) *Seasonal business test.*

(a) *In general.* If the taxpayer's gross receipts from sales and services for the short period and the three immediately preceding taxable years indicate that the taxpayer's business is operational for only part of the year (*e.g.*, due to weather conditions) and, as a result, the taxpayer has insignificant gross receipts during the period the business is not operational, the taxpayer's natural business year is deemed to end at, or soon after, the operations end for the season. A taxpayer that has not been in existence for a sufficient period to provide gross receipts information for the three immediately preceding taxable years may provide information other than gross receipts to demonstrate that it satisfies the requirements of a seasonal business, such as a description of its business and/or reasonable estimates of future gross receipts.

(b) *Safe Harbor.* For purposes of section 5.03(2)(a) of this revenue procedure, an amount equal to less than 10 percent of the taxpayer's total gross receipts for the year will be deemed to be "insignificant," and 1 month will be deemed to be "soon after" the close of operations.

(c) *Example.* B, a partnership, operates a ski resort from November

through March of each year. During September and October, and during April, employees prepare the resort for the ski season, and close it down for the season, respectively. The resort earns less than 10 percent of its annual gross receipts during the period of April through October, when it is closed to guests. B's natural business year is deemed to end at (March 31st), or soon after (April 30th), the close of the resort operations. Accordingly, under the provisions of this revenue procedure, a request by B for a taxable year ending either March 31st or April 30th would be granted, subject to the general terms and conditions of section 5.04 of this revenue procedure.

(3) *25-percent gross receipts test.* A natural business year may be established by any taxpayer other than a member of a tiered structure (as defined in § 444 and § 1.444–2T) using the 25-percent gross receipts test. The 25-percent gross receipts test is determined as follows:

(a) *Prior three years' gross receipts.*

(i) Gross receipts from sales and services for the most recent 12-month period that ends with the last month of the requested annual accounting period are totaled and then divided into the amount of gross receipts from sales and services for the last 2 months of this 12-month period.

(ii) The same computation as in (a)(i) above is made for the two preceding 12-month periods ending with the last month of the requested annual accounting period.

(b) *Natural business year.*

(i) Except as provided in (b)(ii) below, if each of the three results described in (a) equals or exceeds 25 percent, the requested annual accounting period is deemed to be the taxpayer's natural business year.

(ii) The taxpayer must determine whether any annual accounting period other than the requested annual accounting period also meets the 25-percent gross receipts test of paragraph (b)(i). If one or more annual accounting periods produce higher averages of the three percentages (rounded to the 1/100 of a percent) described in (a) than the requested annual accounting period, then the requested annual accounting period will not qualify as the taxpayer's natural business year under the 25-percent gross receipts test.

(c) *Special rules.*

(i) To apply the 25-percent gross receipts test for any particular taxable year, the taxpayer must compute its gross receipts under the method of accounting used to prepare its federal income tax returns for such taxable year.

(ii) Regardless of the taxpayer's method of accounting, the taxpayer's share of income from a pass-through entity generally must be reported as gross receipts in the month that the pass-through entity's taxable year ends.

(iii) If a taxpayer has a predecessor organization and is continuing the same business as its predecessor, the taxpayer must use the gross receipts of its predecessor for purposes of computing the 25-percent gross receipts test.

(iv) If the taxpayer (including any predecessor organization) does not have a 47-month period of gross receipts (36-month period for requested taxable year plus additional 11-month period for comparing requested taxable year with other potential taxable years), then it cannot establish a natural business year using the 25-percent gross receipts test.

(v) If the requested taxable year is a 52–53-week taxable year, the calendar month ending nearest to the last day of the 52–53-week taxable year is treated as the last month of the requested taxable year for purposes of computing the 25-percent gross receipts test.

.04 *General Terms and Conditions.* The following general terms and conditions apply to all taxpayers that obtain approval under this revenue procedure to adopt, change, or retain an annual accounting period:

(1) *Short period tax return.* The taxpayer must file a federal income tax return for the short period required to effect a change in annual accounting period by the due date of that return, including extensions pursuant to § 1.443–1(a). The taxpayer's taxable income for the short period generally must be annualized and the tax must be computed in accordance with the provisions of § 443(b) and § 1.443–1(b). However, for changes to (or from) a 52–53-week taxable year referencing the same month as the current (or requested) taxable year, see special rules in § 1.441–2. See also, for example, §§ 1.706–1(b)(8)(i)(B), 1.852–3(e), 1.857–2(a)(4), 1.1378–1(c)(2), and 1.1502–76 for exceptions to the annualization rule for a partnership, RIC, REIT, S corporation, and subsidiary corporation ceasing to be a member of a consolidated group, respectively.

(2) *Subsequent year tax returns.* Returns for subsequent taxable years generally must be made on the basis of a full 12 months (or on a 52–53-week basis) ending on the last day of the requested taxable year, unless the taxpayer secures the approval of the Commissioner to change its requested taxable year.

(3) *Record keeping/book conformity.* The books of the taxpayer must be closed as of the last day of the first effective year. Thereafter, the taxpayer must compute its income and keep its books and records (including financial statements and reports to creditors) on the basis of the requested taxable year, except that this requirement shall not apply (1) to books and records maintained solely for foreign law purposes (*e.g.*, foreign tax reporting purposes), or (2) if the requested taxable year is either the taxpayer's required taxable year or ownership taxable year.

(4) *Changes in natural business year.* If a partnership, S corporation, electing S corporation, or PSC changes to or retains a natural business year under this revenue procedure and that annual accounting period no longer qualifies as a permitted taxable year, the taxpayer is using an impermissible annual accounting period and should change to a permitted taxable year. Certain partnerships, S corporations, electing S corporations, and PSCs may qualify for automatic approval to change their annual accounting period under Rev. Proc. 2002–38. Other taxpayers must request approval under this revenue procedure.

(5) *52–53-week taxable years.* If applicable, the taxpayer must comply with § 1.441–2(e) (relating to the timing of taking items into account in those cases where the taxable year of a pass-through entity or PSC ends with reference to the same calendar month as one or more of its partners or shareholders or employee-owners).

(6) *Creation of net operating loss or capital loss.* If the taxpayer generates a net operating loss (NOL) or capital loss

(CL) in the short period required to effect a change in annual accounting period, the taxpayer may not carry the NOL or CL back, but must carry it over in accordance with the provisions of §§ 172 and 1212, respectively, beginning with the first taxable year after the short period. However, except as otherwise provided in the Code or regulations (*e.g.*, § 280H and the regulations thereunder in the case of a PSC) the short period NOL or CL is carried back or carried over in accordance with §§ 172 or 1212, respectively, if it is either: (a) $50,000 or less, or (b) results from a short period of 9 months or longer and is less than the NOL or CL for a full 12-month period beginning with the first day of the short period.

(7) *Creation of general business credits*. If there is an unused general business credit or any other unused credit generated in the short period, the taxpayer must carry that unused credit forward. An unused credit from the short period may not be carried back.

(8) *Concurrent change for related entities*. In appropriate cases, if a taxpayer owns a majority interest in a pass-through entity, the entity will be required to concurrently change its annual accounting period as a term and condition of the approval of the taxpayer's request to change its annual accounting period, notwithstanding the testing date provisions in §§ 706(b)(4)(A)(ii), 898(c)(1)(C)(ii), § 1.921–1T(b)(6), and the special provision in § 706(b)(4)(B). If this condition applies, the pass-through entity must comply with the appropriate procedures to obtain approval for the change. *See, e.g.*, Rev. Proc. 2002–37 and Rev. Proc. 2002–38.

.05 *Additional Terms, Conditions, and Adjustments*. The additional terms, conditions, and adjustments described in this section 5.05 apply to taxpayers that obtain approval under this revenue procedure to change an annual accounting period and that establish a business purpose under section 5.02(2) of this revenue procedure. These additional terms, conditions, and adjustments are necessary to neutralize the tax effects of a substantial distortion of income that otherwise would result from the change, including: a deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one taxable year to another; a similar deferral or shifting in the case of any other person, such as a beneficiary of an estate; the creation of a short period in which there is a substantial NOL, CL, or credit (including a general business credit), or the creation of a short period in which there is a substantial amount of income to offset an expiring NOL, CL, or credit.

(1) *Substantial distortion*. Distortion of income will not be considered substantial, and no adjustments under this section 5.05 will be required for such distortion, if the amount of the distortion is less than both:

(i) five percent of the taxpayer's estimated gross receipts for its current taxable year (computed as if the taxpayer remained on its existing taxable year); and

(ii) $500,000.

(2) *Deferral of substantial pass-through income*.

(a) *In general*. An adjustment will be required under this section 5.05(2) if the change creates a substantial distortion of income as a result of increasing the deferral of the taxpayer's distributive share of income from a pass-through entity between the taxable year of the pass-through entity and the taxpayer's taxable year. For this purpose, if the pass-through entity's taxable year is determined based on the taxable year of its owners, the taxpayer must compare the existing deferral period (*i.e.*, between the pass-through entity's and the taxpayer's current taxable years) with the proposed deferral period (*i.e.*, between the taxable year of the pass-through entity that would be required after the requested change and the taxpayer's requested taxable year) to determine whether the deferral period is increased. If the taxpayer indirectly owns an interest in a pass-through entity through one or more other pass-through entities, the existing and proposed deferral periods generally must be determined by comparing the taxable year of the directly-owned pass-through entity with the taxpayer's taxable year. However, if the proposed change does not increase the deferral period between the taxable year of the directly-owned pass-through entity and the taxpayer's taxable year, the existing and proposed deferral periods must be determined by comparing the taxable year of the next lower-tier indirectly-owned pass-through entity with the taxpayer's taxable year until either: (1) an increase in the deferral period is found or (2) the next lower-tier entity either does not exist or is not a pass-through entity.

(b) *Computing deferral*. The amount of deferral that results from the change is the taxpayer's allocable share of income from each pass-through entity described in (a), including ordinary income or loss, capital gain or loss, rents, royalties, interest, dividends, and the deduction equivalents of credits that accrue during the taxpayer's first effective year. In the case of a partnership, the taxpayer's share of income also includes guaranteed payments to the taxpayer that are both deductible by the partnership under its method of accounting during the partnership's first taxable year ending after the taxpayer's first effective year and attributable (on a ratable basis) to the taxpayer's first effective year. A taxpayer must aggregate the deferral of income from each pass-through entity described in (a). However, if the aggregate deferral of income from all pass-through entities described in (a) is negative (*i.e.*, an aggregate loss), there is no deferral of income. For this purpose, the taxpayer may use reasonable estimates to determine the income that accrues during the first effective year. The Service may, on examination, use any available data, including information on previous years' Schedules K–1, to verify the reasonableness of the taxpayer's estimates.

(c) *Adjustment*. If the deferral of income computed in section 5.05(2)(b) of this revenue procedure represents a substantial distortion of income (as defined in section 5.05(1)), the taxpayer must include the entire amount of the distortion (and not merely the excess over the amounts specified in section 5.05(1)) as ordinary income for the first effective year. The taxpayer also must report its allocable share of income from the pass-through entity in the taxable year following the first effective year in accordance with general tax principles (*e.g.*, § 706). The taxpayer must establish a suspense account for the amount included in ordinary income for the first effective year and deduct this amount ratably over the

four taxable years immediately succeeding the first effective year. Notwithstanding the preceding sentence, if all or a portion of the suspense account is attributable to an interest in a pass-through entity that is subsequently disposed of, any amount so attributable that remains in the suspense account in the year of the disposition may be deducted in that year. In all cases, the deduction under this paragraph will be treated as an ordinary deduction. The adjustments described in this section do not affect the taxpayer's basis in the pass-through entity (such as basis in a partnership determined under § 705). *See* Examples 1, 2, and 3, section 5.06 of this revenue procedure.

(3) *Special rule for certain pass-through entities*. An adjustment similar to that described in this paragraph 5.05(2) will be required in the case of a deferral of income or shifting of deductions to another taxpayer, such as a beneficiary of an estate.

(4) *Use of expiring NOLs, CLs, and credits*. An adjustment will be required under this section 5.05(4) if the change creates a substantial distortion of income as a result of the creation of income in the short period (or the shifting of foreign taxes paid or accrued) to offset expiring NOLs, CLs, or credits (including general business credits). The amount of distortion that results from a change is the amount by which any NOL, CL, and credit that is carried over to the first effective year and that expires in that year exceeds the NOL, CL, and credit that could have been used to offset income in the taxpayer's current taxable year (computed as if the taxpayer remained on its existing taxable year). If this distortion is substantial (as defined in section 5.05(1)), any NOL, CL, or credit carried over to the first effective year will be allowed to offset income in the first effective year only to the extent that such NOL, CL, or credit could have been used to offset income in the taxpayer's current taxable year. *See* Example 4, section 5.06 of this revenue procedure.

(5) *Other terms, conditions, and adjustments*. In addition to the terms, conditions, and adjustments described in this section 5.05, the Service may impose any other term, condition, or adjustment that it deems appropriate under the circumstances.

.06 *Examples*. The following examples illustrate the additional terms, conditions, and adjustments that may be required under section 5.05 of this revenue procedure to obtain the Commissioner's approval for a change of an annual accounting period. In all examples, the taxpayer is within the scope of this revenue procedure, the taxpayer has established a business purpose under section 5.02(2) of this revenue procedure, and any distortion of income resulting from the change is substantial.

Example 1. P, a foreign corporation, maintains its books and files its foreign country tax returns on the basis of a taxable year ending on May 31st. In 2001, P acquires all the stock of S, a domestic corporation, that maintains its books and files its tax returns on the calendar year. S has a minority interest in a partnership that uses the calendar year. In order to facilitate the filing of consolidated financial statements for P and S, S applies for approval to change its taxable year to a taxable year ending on May 31st beginning on May 31, 2002. The change will create a substantial distortion of income as a result of increasing the deferral of S's distributive share of income from its partnership interest. Consequently, S will be required, under section 5.05(2) of this revenue procedure, to report the partnership income that accrues between January 1 and May 31, 2002, as an ordinary income adjustment on its short period tax return as a term, condition, and adjustment of the change. Thereafter, on subsequent tax returns filed for its taxable year ending on May 31st (beginning May 31, 2003), S must report the partnership income for the partnership's taxable year ending December 31 based on the Schedule K–1 in accordance with § 706. To take into account S's double inclusion of the 5 months of partnership income from January 1 to May 31, 2002, S must recognize an ordinary deduction adjustment in each of the four taxable years following the first effective year equal to one-fourth of the ordinary income adjustment amount included on S's short period tax return. Neither adjustment will affect S's basis in the partnership.

Example 2. D is a domestic corporation that currently maintains its books and files its tax returns on the calendar year, but applies in 2002 for approval to change its taxable year to a year ending on May 31st. D owns a majority interest in a partnership, PS1, which in turn owns a minority interest in another partnership, PS2. PS1 and PS2 have taxable years ending on December 31st and September 30th, respectively, as required by the majority interest rule of § 706(b)(1)(b)(i). If D changes its annual accounting period to May 31st, and the first effective year ends on May 31, 2002, PS1 will be required to conform its taxable year with D using a first effective year of May 31, 2002, as required under section 5.04(8) of this revenue procedure. Accordingly, D's requested change in its taxable year would not increase the deferral of D's distributive share of income or gain from PS1. However, PS2 will retain its September 30th taxable year; thus, D's requested change will increase the deferral of D's distributive share of income and gain from PS2, which is passed through to D from PS1. Assuming the deferral results in a substantial distortion of income, D will be required, under section 5.05(2) of this revenue procedure, to report its distributive share of PS2's income and gain accruing between January 1, 2002, and May 31, 2002, as an ordinary income adjustment on its tax return for the short period ending May 31st as a term and condition of the change in D's taxable year.

Example 3. The facts are the same as in Example 2, except that PS2 owns a minority interest in partnership PS3, which has a December 31st taxable year. Because D will be required as a term and condition of the change in D's taxable year to report its distributive share of PS2's income and gain accruing between January 1, 2002, and May 31, 2002, and because that distributive share will include a portion of PS2's distributive share of income from PS3, D does not need to make any additional ordinary income adjustment to take account of any increased deferral from PS3.

Example 4. Y, a domestic corporation that files its tax returns on the calendar year, applies in 2002 for consent to change its taxable year to a year ending on May 31st. Y has a general business credit carryover of $100x that will expire in the current taxable year. Y reasonably expects to incur on June 30, 2002, a substantial amount that is deductible for federal income tax purposes. If Y changes its annual accounting period to May 31st, and the first effective year ends on May 31, 2002, Y reasonably expects it would be able to use $90x of the $100x credit. However, if Y continues to use the calendar year for 2002, Y reasonably estimates that it would be able to use only $25x of the expiring credit. Under section 5.05(4) of this revenue procedure, Y will be allowed to use only $25x of the credit to offset income in the first effective year as a term, condition, and adjustment of the change.

SECTION 6. GENERAL APPLICATION PROCEDURES

.01 *What to File*.

(1) *Application*. To request the Commissioner's approval to adopt, change, or retain an annual accounting period under this revenue procedure, a taxpayer (other than an electing S corporation) must complete, sign, and file a

current Form 1128, *Application to Adopt, Change, or Retain a Tax Year.* An electing S corporation requesting to adopt, change, or retain an annual accounting period must complete the appropriate section of, and sign and file, a current Form 2553, *Election by a Small Business Corporation.*

(2) *Signature requirement.* The application must be signed by the taxpayer or on behalf of the taxpayer requesting the adoption, change, or retention of annual accounting period by an individual with authority to bind the taxpayer in such matters. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a state law partnership, a member-manager on behalf of a limited liability company, a trustee on behalf of a trust, or an individual taxpayer on behalf of a sole proprietorship. If the taxpayer is a member of a consolidated group, a Form 1128 submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. If an agent is authorized to represent the taxpayer before the Service, receive the original or a copy of the correspondence concerning the request, or perform any other act(s) regarding the application filed on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to the application. A taxpayer's representative without a power of attorney to represent the taxpayer as indicated in this section will not be given any information regarding the application.

(3) *Additional information regarding prior applications.*

(a) *Accounting period changed.* If a taxpayer changed its annual accounting period at any time within the most recent 48-month period ending with the last month of the requested taxable year (under either an automatic change procedure or a procedure requiring prior approval), a copy of the application for the previous change, the ruling letter, and any other related correspondence from the Service must be attached to the application filed for the requested taxable year.

(b) *Accounting period not changed.* If a prior application (filed under either an automatic change procedure or a procedure requiring prior approval) was withdrawn, not perfected, or denied, or if the change in annual accounting period was not made, and the taxpayer files another application to change its annual accounting period within the most recent 48-month period ending with the last month of the requested taxable year, a copy of the earlier application, together with any related correspondence from the Service, must be attached to the application filed for the requested taxable year. An explanation must be furnished stating why the earlier application was withdrawn or not perfected or why the change in annual accounting period was not made. The Service will consider the explanation in determining whether the subsequent request for a change in the taxpayer's annual accounting period will be granted.

(4) *Additional information for section 5.03(1) and (2).* If the taxpayer requests to establish a natural business year under section 5.03(1) or (2) of this revenue procedure, it must provide its gross receipts from sales or services and approximate inventory costs (where applicable) for each month in the requested short period and for each month of the three immediately preceding taxable years.

(5) *Additional information for section 5.03(3).* In the case of a taxpayer requesting to change to a natural business year that satisfies the 25-percent gross receipts test described in section 5.03(3) of this revenue procedure, the taxpayer must supply the gross receipts for the most recent 47 months for itself (or any predecessor) in compliance with the instructions to Form 1128.

(6) *Additional information for section 5.04.* The taxpayer must indicate whether it has an NOL or CL in the short period required to effect the change and provide the type and amount of any credits generated in the short period.

(7) *Additional information for section 5.05.* If a taxpayer requests to change an annual accounting period and establishes a business purpose under section 5.02(2) of this revenue procedure, the taxpayer must provide the following additional information necessary to determine whether a substantial distortion of income (within the meaning of section 5.05(1)) exists and, thus, whether the additional terms, conditions, and adjustments of section 5.05 apply:

(a) if the taxpayer has an interest in a pass-through entity:

(i) reasonable estimates of the taxpayer's taxable income for its current taxable year (computed as if the taxpayer remained on its existing taxable year);

(ii) a comparison of the existing deferral period of any pass-through entity in which the taxpayer has a direct or, as appropriate, indirect interest (*i.e.*, the period between the pass-through entity's and the taxpayer's current taxable years) with the proposed deferral period for such pass-through entity (*i.e.*, the period between the taxable year of the pass-through entity that would be required after the requested change and the taxpayer's requested taxable year); and

(iii) reasonable estimates of the aggregate deferral of income from all pass-through entities described in section 5.05(1)(a);

(b) the amount of any NOL, CL, or credit carried over to the first effective year and the taxable year in which such NOL, CL, or credit was generated; and

(c) identification of any partnership, specified foreign corporation (as defined in § 898), foreign sales corporation (as defined in former § 922), or domestic international sales corporation (as defined in § 992) in which the taxpayer has a majority interest.

.02 *When to File.*

(1) *In general.* Except as provided in section 6.02(2) of this revenue procedure, a taxpayer must file a Form 1128 no earlier than the day following the end of the first effective year and no later than the due date (not including extensions) of the federal income tax return for the first effective year. However, the Service recommends that the Form 1128 be filed as early as possible to provide the Service adequate time to respond to the request prior to the due date (including extensions) of the taxpayer's federal income tax return for the first effective year. In the case of a change that results in a short period of six days or less, the Form 1128 also must be filed no earlier than the day following the end of the short period and no later than the due date (not including extensions) of the federal income tax return for the short period, even though the short period is not treated as a separate taxable year under § 1.441–2(b)(2). A taxpayer that fails to file a Form 1128

within the time period prescribed in this section 6.02(1) may request an extension of time to file under § 301.9100 of the Procedure and Administration Regulations. Under § 301.9100–3, a Form 1128 filed within 90 days after the time period prescribed in this section 6.02(1) may be considered as timely filed if the taxpayer establishes that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. If a Form 1128 is filed more than 90 days after this period, prejudice to the interests of the government will be presumed and such requests will be approved only in unusual and compelling circumstances. *See* § 301.9100–3(c)(3).

(2) *Electing S corporations.* An electing S corporation must file a Form 2553 when the election to be an S corporation is filed pursuant to § 1362(b) and § 1.1362–6. Generally, such election must be filed at any time during (a) the taxable year that immediately precedes the taxable year for which the election is to be effective or (b) the taxable year for which the election is to be effective, provided the election is made before the 16th day of the third month of the taxable year.

.03 *Where to File.*

(1) *In general.* A taxpayer, other than an electing S corporation or exempt organization, applying for an adoption, change, or retention in annual accounting period pursuant to this revenue procedure must file its Form 1128, together with the appropriate user fee, with the Service at the following address: Internal Revenue Service, Associate Chief Counsel (Income Tax & Accounting), Attention: CC:PA:T:CRU, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044 (or, in the case of a designated private delivery service: Internal Revenue Service, Associate Chief Counsel (Income Tax & Accounting), Attention: CC:PA:T:CRU, Room 6561, 1111 Constitution Avenue, N.W., Washington, DC 20224).

(2) *Electing S corporations.* An electing S corporation requesting to adopt, change, or retain an annual accounting period pursuant to this revenue procedure must file its Form 2553 with the appropriate Service Center designated in the instructions to the Form 2553. The taxpayer should not include the user fee with the Form 2553 mailed to the Service Center. The Service Center will send the Form 2553 to the national office of the Service, which will then notify the taxpayer that the fee is due.

(3) *Exempt organizations.* An exempt organization applying for a change in annual accounting period pursuant to this revenue procedure must file its Form 1128, together with the appropriate user fee, with the Service at the following address: Internal Revenue Service, Attention: T:EO:RA, P.O. Box 27720, McPherson Station, Washington, DC 20038.

.04 *User Fee.* Taxpayers are required to pay user fees for requests to adopt, change, or retain an annual accounting period under this revenue procedure. Rev. Proc. 2002–1 and, for tax-exempt organizations, Rev. Proc. 2002–8, 2002–1 I.R.B. 259 (or any successors) contain the schedule of user fees and provide guidance for complying with the user fee requirements.

.05 *Consolidated Groups — Separate Forms 1128 Not Required.* A common parent of a consolidated group files a single Form 1128 on behalf of the consolidated group and pays only a single user fee. The common parent must indicate that the Form 1128 is for the common parent and all its subsidiaries and answer all relevant questions on the application for each member of the consolidated group. If one or more of the members of the group is requesting to use a 52–53-week taxable year that ends within the same 7-day period of the other members' requested taxable year, the parent must attach a statement to its tax return for the first effective year as required by Rev. Proc. 89–56, 1989–2 C.B. 643 (or any successor). The consolidated group must also comply with all of the provisions of Rev. Rul. 72–184, 1972–1 C.B. 289 (or any successor). *See* § 1.1502–76(a)(1).

.06 *Additional Procedures If Under Examination, Before an Area Office, or Before a Federal Court.*

(1) *Certain taxpayers under examination.*

(a) A partnership, S corporation, electing S corporation, or PSC that is under examination may apply for approval to change or retain its annual accounting period under this revenue procedure only if the appropriate director consents to the change or retention. The director will consent to the change or retention unless in the opinion of the director, such entity's annual accounting period ordinarily would be included as an item of adjustment in the year(s) for which the entity is under examination. For example, the director will consent to a change where the entity is using a permissible annual accounting period. The director also will consent to a change from an impermissible annual accounting period where the period became impermissible (*e.g.*, due to a change in ownership or a change in the entity's business) subsequent to the years under examination. The question of whether the annual accounting period from which the entity is changing is permissible or became impermissible subsequent to the years under examination may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2002–2 (or any successor) or, for tax-exempt organizations, Rev. Proc. 2002–5 (or any successor).

(b) A partnership, S corporation, electing S corporation, or PSC changing or retaining an annual accounting period under this revenue procedure with the consent of the appropriate director must attach to the application a statement from the director consenting to the change or retention. The partnership, S corporation, electing S corporation, or PSC must provide a copy of the application to the director at the same time it files the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s).

(2) *Certain taxpayers before an area office.* A partnership, S corporation, electing S corporation, or PSC that is before an area office must attach to the application a separate statement signed by an appropriate person certifying that, to the best of that person's knowledge, the entity's annual accounting period is not an issue under consideration by the area office. The entity must provide a copy of the application to the appeals officer at the same time it files the application with the national office. The application must contain the name and telephone number of the appeals officer.

(3) *Certain taxpayers before a federal court.* A partnership, S corporation,

electing S corporation, or PSC that is before a federal court must attach to the application a separate statement signed by an appropriate person certifying that, to the best of that person's knowledge, the entity's annual accounting period is not an issue under consideration by the federal court. The entity must provide a copy of the application to the government counsel at the same time it files the application with the national office. The application must contain the name and telephone number of the government counsel.

SECTION 7. PROCESSING OF APPLICATION

.01 *Service Discretion*. Notwithstanding any other provision of this revenue procedure, the Service reserves the right to decline to process any application filed under this revenue procedure in situations in which it would not be in the best interest of sound tax administration to permit the requested adoption, change, or retention. In this regard, the Service will consider whether the adoption, change, or retention in annual accounting period would clearly and directly frustrate compliance efforts of the Service in administering the income tax laws.

.02 *Applicability of Rev. Proc. 2002–1, Rev. Proc. 2002–4, and Any Successor Revenue Procedures*. Rev. Proc. 2002–1 or, for tax-exempt organizations, Rev. Proc. 2002–4, 2002–1 I.R.B. 127 (or any successors) will apply to any request made under this revenue procedure to adopt, change, or retain an annual accounting period.

.03 *Incomplete Application — 21 Day Rule*. If the Service receives an application that is not completed properly in accordance with the instructions on the Form 1128 (or Form 2553) and the provisions of this revenue procedure, or if supplemental information is needed, the Service will notify the taxpayer. The notification will specify the information that needs to be provided, and the taxpayer will be permitted 21 days from the date of the notification to furnish the necessary information. The Service reserves the right to impose shorter reply periods if subsequent requests for additional information are made. If the required information is not submitted to the Service within the reply period, the application will not be processed. A reasonable additional period to furnish information may be granted to a taxpayer. Any request for an extension of time to furnish necessary information must be made in writing and submitted within the 21-day period. If the extension request is denied, there is no right of appeal.

.04 *Conference in the National Office*. The taxpayer must complete the appropriate line on the Form 1128, or attach a statement to the Form 2553, to request a conference of right if an adverse response is contemplated by the Service. If the taxpayer does not complete the appropriate line on the Form 1128, attach a statement to the Form 2553, or request a conference in a later written communication, the Service will presume that the taxpayer does not desire a conference. If requested, a conference will be arranged in the national office prior to the Service's formal reply to the taxpayer's application. For taxpayers other than exempt organizations, see section 11 of Rev. Proc. 2002–1 (or any successor). For exempt organizations, see section 12 of Rev. Proc. 2002–4 (or any successor).

.05 *Letter Ruling*. Unless otherwise specifically provided, the Commissioner's approval to adopt, change, or retain a taxpayer's annual accounting period will be set forth in a letter ruling from the national office that identifies the taxpayer's former annual accounting period; the annual accounting period the taxpayer is adopting, changing to, or retaining; the short period necessary to effect a change; and the terms, conditions, and adjustments under which the adoption, change, or retention is to be effected. *See* § 1.442–1(b). A copy of the letter ruling must be attached to the taxpayer's federal income tax return for the first effective year.

.06 *Effect of Noncompliance*. If a taxpayer adopts, changes, or retains an annual accounting period without authorization or without complying with all of the provisions of this revenue procedure and the letter ruling granting permission for the change, the taxpayer has initiated an adoption, change, or retention of annual accounting period without obtaining the approval of the Commissioner as required by §§ 441(i), 442, 706(b), and 1378. Upon examination, a taxpayer that has initiated an unauthorized adoption, change, or retention of annual accounting period may be denied the adoption, change, or retention. For example, the taxpayer may be required to recompute its taxable income or loss in accordance with its former (or required, if applicable) taxable year.

.07 *Effect on Other Offices of the Service*. The provisions of this revenue procedure are not intended to preclude an appropriate representative of the Service (for example, an appeals officer with delegated settlement authority) from settling a particular taxpayer's case involving an accounting period issue by agreeing to terms, conditions, and adjustments that differ from those that might be provided under this revenue procedure when it is in the best interest of the government to do so.

SECTION 8. EFFECT OF APPROVAL

.01 *Audit Protection*.

(1) *In general*. Except as provided in section 8.01(2) of this revenue procedure, a partnership, S corporation, electing S corporation, or PSC that files an application in compliance with all the applicable provisions of this revenue procedure will not be required by the Service to change its annual accounting period for a taxable year prior to the first effective year.

(2) *Exceptions*. The Service may change the annual accounting period of a taxpayer described in section 8.01(1) of this revenue procedure for a prior taxable year if:

(a) the taxpayer withdraws or does not perfect its request;

(b) the national office denies the request;

(c) the taxpayer declines to implement the change;

(d) the taxpayer implements the change but does not comply with all the applicable provisions of this revenue procedure and the letter ruling granting permission for the change; or

(e) the national office modifies or revokes the ruling because there has been a misstatement or omission of material facts.

.02 *Subsequently Required Changes*.

(1) *In general*. A taxpayer described in section 8.01(1) of this revenue procedure that adopts, changes, or retains its annual accounting period pursuant to this revenue procedure may be required to

subsequently change its annual accounting period for the following reasons:

(a) the enactment of legislation;

(b) a decision of the United States Supreme Court;

(c) the issuance of temporary or final regulations;

(d) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin;

(e) the issuance of written notice to the taxpayer that the change in accounting period was granted in error or is not in accord with the current views of the Service; or

(f) a change in the material facts on which the approval was based.

(2) *Retroactive change or modification.* Except in rare or unusual circumstances, if a taxpayer described in section 8.01(1) of this revenue procedure adopted, changed, or retained its annual accounting period under this revenue procedure and is subsequently required under section 8.02(1) of this revenue procedure to change its annual accounting period, the required change will not be applied retroactively provided that:

(a) the taxpayer complied with all the applicable provisions of the letter ruling granting permission for the change and this revenue procedure;

(b) there has been no misstatement or omission of material facts;

(c) there has been no change in the material facts on which the approval was based;

(d) there has been no change in the applicable law; and

(e) the taxpayer to whom approval was granted acted in good faith in relying on the approval and applying the change retroactively would be to the taxpayer's detriment.

SECTION 9. REVIEW BY DIRECTOR

.01 *In General.* A director must apply a ruling obtained under this revenue procedure in determining the taxpayer's tax liability unless the director recommends that the ruling should be modified or revoked. The director will ascertain if:

(1) the representations on which the ruling was based reflect an accurate statement of the material facts;

(2) the amount of the adjustments required to effect the change, if any, were properly determined;

(3) the adoption, change, or retention of annual accounting period was implemented as proposed in accordance with the terms and conditions of the letter ruling and this revenue procedure;

(4) there has been any change in the material facts on which the ruling was based during the period that the new or retained annual accounting period was used; and

(5) there has been any change in the applicable law during the period the new or retained annual accounting period was used.

.02 *National Office Consideration.* If a director recommends that the ruling (other than the amount of the adjustments required to effect the change) should be modified or revoked, the director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 2002–2 or, for tax-exempt organizations, Rev. Proc. 2002–5 will be followed.

SECTION 10. EFFECTIVE DATE AND TRANSITION RULE

.01 *In General.* Except as provided in section 10.02 of this revenue procedure, this revenue procedure is effective for applications filed on or after May 10, 2002.

.02 *Transition Rule for Pending Applications.* If a taxpayer filed an application before May 10, 2002, and the application is pending with the national office on May 10, 2002, the taxpayer may request that the application be processed in accordance with this revenue procedure. However, the national office will process applications filed before May 10, 2002, in accordance with prior authorities unless, prior to the later of June 25, 2002, or the issuance of the letter ruling granting or denying consent to the adoption, change, or retention, the taxpayer notifies the national office that it requests that its application be processed in accordance with this revenue procedure.

SECTION 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 85–16 and Rev. Proc. 74–33 are superseded.

SECTION 12. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1786. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are found in sections 6, 7, and 10. The information in section 6 is required in order to determine whether the taxpayer's annual accounting period will result in a distortion of income. This information will be used by the Service to determine which terms, conditions, and adjustments will be necessary to effect the adoption, change, or retention of annual accounting period. The information in section 7 is required in order to determine whether the taxpayer desires a conference of right if an adverse response to its application is contemplated. The information in section 10 is required in order to allow a taxpayer to apply the provisions of this revenue procedure to a pending application. The likely respondents are the following: individuals, corporations, associations, trusts, estates, partnerships, farms, business or other for-profit organizations, non-profit organizations, and small businesses or organizations.

Except for the burdens contained in sections 6.01(5), 6.01(6), 7.04 (Forms 2553 only), and 10.02, the total annual reporting burden for the requirements contained in this revenue procedure is reflected in the burden estimates for Forms 1128 and 2553.

The estimated total annual reporting burden for the requirements contained in sections 6.01(5), 6.01(6), 7.04, and 10.02 of this revenue procedure is 600 hours: the estimated average annual burden per respondent is 1.2 hours; the estimated number of respondents is 500; and the estimated frequency of response is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The author of this revenue procedure is Martin Scully, Jr. of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Scully at (202) 622–4960 (not a toll-free call).

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Regarding the Definition of Foreign Personal Holding Company Income

REG–154920–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide that gain or loss arising from certain commodities hedging transactions and currency gain or loss arising from certain interest-bearing liabilities do not constitute (or are not netted against) foreign personal holding company income. This treatment is proposed because the applicable commodities hedging transactions and interest-bearing liabilities typically offset transactions that do not generate foreign personal holding company income. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 21, 2002. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for September 11, 2002, at 10 a.m. must be submitted by August 21, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–154920–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU, REG–154920–01, Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Kenneth Christman or Ted Setzer at (202) 622–3870; concerning submission and delivery of comments and the public hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 954(c)(1)(C) of the Internal Revenue Code provides that *foreign personal holding company income* of a *controlled foreign corporation* (a CFC) generally includes the excess of gains over losses from transactions in commodities. An exception to this treatment is provided, however, for gains and losses that arise out of "*bona fide* hedging transactions" entered into by a producer, processor, merchant or handler of commodities. Section 954(c)(1)(C)(i). On September 7, 1995, final regulations (T.D. 8618, 1995-2 C.B. 89) were published in the **Federal Register** (60 FR 46500, as corrected at 60 FR 62024) under section 954 governing the definition of a CFC and the definitions of *foreign base company income* and *foreign personal holding company income* of a CFC. These regulations address, among other matters, the circumstances in which income from transactions in commodities will be treated as foreign personal holding company income. In particular, the regulations provide that income from a "qualified hedging transaction" is excluded from the definition of foreign personal holding company income. § 1.954–2(f)(1)(ii). A qualified hedging transaction is defined in the regulations generally as a *bona fide* hedging transaction with respect to a sale of commodities in the active conduct of a commodities business by a CFC if substantially all of the CFC's business is as an active producer, processor, merchant or handler of commodities. §§ 1.954–2(f)(2)(iii) and (iv).

Following the publication of the final regulations, some taxpayers have commented that the regulations inappropriately characterize as foreign personal holding company income any gain arising from hedging transactions entered into by a manufacturer to protect itself from fluctuations in the prices of commodities associated with the products that it manufactures. Because the manufacturer would not be considered to be selling the commodities in the active conduct of a commodities business, transactions entered into by the manufacturer could not qualify for the "qualified hedging transaction" exception under the regulations.

The regulations also address the treatment of currency gain or loss for purposes of subpart F. Although the regulations provide that foreign personal holding company income generally includes the excess of foreign currency gains over foreign currency losses, an exception is provided for foreign currency gain or loss "directly related to the business needs of the controlled foreign corporation." § 1.954–2(g)(2)(ii). Notwithstanding this "business needs" exception, the regulations provide that currency gain or loss arising from an interest-bearing liability must be allocated and apportioned between subpart F and non-subpart F income in the same manner that interest expense associated with the liability is allocated and apportioned between subpart F and non-subpart F income under §§ 1.861–9T and 1.861–12T. § 1.954–2(g)(2)(iii).

Some taxpayers have commented that the final regulations inappropriately characterize a portion of foreign currency gain on certain interest-bearing liabilities as foreign personal holding company income. In particular, these taxpayers have noted that securities dealers commonly utilize a technique known as "match funding" to manage currency exposures associated with their dealer assets. Rather than borrowing in their functional currency to meet their business needs, dealers who utilize this technique attempt to manage their exposure to foreign currencies on their dealer assets by borrowing the funds needed for their business in the currency in which the dealer assets are denominated. As a result, the foreign currency exposure on the dealer assets is offset economically by the

foreign currency exposure on the interest-bearing liabilities incurred by the dealer. Under the regulations, foreign currency gain on the dealer assets would qualify for the "business needs" exception and therefore would not be classified as foreign personal holding company income. If the foreign currency gain arose on the offsetting interest-bearing liabilities, however, a portion of the foreign currency gain likely would be treated as subpart F income under the regulations.

Explanation of Provisions

The proposed regulations address each of these issues by refining the relevant exceptions to foreign personal holding company income.

Commodities Hedging Transactions

Section 1.954–2(f)(2)(v), as proposed, would provide that a hedging transaction entered into by a CFC with respect to its business as a producer, processor, merchant or handler of commodities may be a qualified hedging transaction although the hedging transaction is not a hedge with respect to a sale of commodities in the active conduct of a commodities business by a CFC substantially all of whose business is as an active producer, processor, merchant or handler of commodities. The proposed regulation also provides that, for purposes of satisfying the qualified hedging transaction requirements, a producer, processor, merchant or handler of commodities includes (but is not limited to) a CFC that regularly uses commodities in a manufacturing, construction, utilities, or transportation business. Similar to the regulations currently in effect, the proposed regulations provide that a corporation is not a producer, processor, merchant or handler of commodities (and therefore cannot satisfy the qualified hedging transaction requirements) if its business is primarily financial.

Foreign Currency Gain or Loss on Interest-bearing Liabilities

Section 1.954–2(g)(2)(ii)(C)(*2*), as proposed, would provide that interest-bearing liabilities of a CFC will be treated as dealer property if the liabilities are denominated in a currency so as to manage the CFC's currency risk with respect to dealer property held by the CFC. This provision would apply only to interest-bearing liabilities identified on the date the liability is incurred. The result of the proposed rule would be to exclude currency gain or loss on interest-bearing liabilities that manage the CFC's currency risk with respect to dealer property from the computation of foreign personal holding company income.

Proposed Effective Dates

Section 1.954–2(f)(2)(v) is proposed to apply to gain or loss realized by a CFC with respect to a qualified hedging transaction entered into on or after the date proposed § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**. Section 1.954–2(g)(2)(ii)(C)(*2*) is proposed to apply to gain or loss from an interest-bearing liability entered into by a CFC on or after the date proposed § 1.954–2(g)(2)(ii)(C)(*2*) is published as a final regulation in the **Federal Register**.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 11, 2002, at 10 a.m. in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by August 21, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Kenneth Christman and Ted Setzer of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.954–0, paragraph (b) is amended by:

1. Removing the entry for § 1.954–2(f)(2)(iii)(E).

2. Revising the entry for § 1.954–2(f)(2)(iv).

3. Adding entries for § 1.954–2(f)(2)(iv)(C), (f)(2)(v) and (f)(2)(vi).

4. Revising the entry for § 1.954–2(g)(2)(ii)(C).

The additions and revisions read as follows::

§ 1.954–0 Introduction.

* * * * *

(b) * * *

§ 1.954–2 Foreign personal holding company income.

* * * * *

(f) * * *

(2) * * *

(iv) Qualified hedging transaction entered into prior to the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

* * * * *

(C) Effective date.

(v) Qualified hedging transaction entered into on or after the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(A) In general.

(B) Exception.

(C) Examples.

(D) Effective date.

(vi) Financial institutions not a producer, etc.

(g) * * *

(2) * * *

(ii) * * *

(C) Regular dealers.

(*1*) General rule.

(*2*) Certain interest-bearing liabilities treated as dealer property.

(i) In general.

(ii) Failure to identify certain liabilities.

(iii) Effective date.

* * * * *

Par. 3. Section 1.954–2 is amended by:

1. Removing paragraph (f)(2)(iii)(E).

2. Revising the heading of paragraph (f)(2)(iv).

3. Adding paragraphs (f)(2)(iv)(C), (f)(2)(v), and (f)(2)(vi).

4. Revising paragraphs (g)(2)(C) and (g)(2)(iii).

The revisions and additions read as follows:

§ 1.954–2 Foreign personal holding company income.

* * * * *

(f) * * *

(2) * * *

(iv) Qualified hedging transaction entered into prior to the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

* * * * *

(C) *Effective date*. This paragraph (f)(2)(iv) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into prior to the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(v) *Qualified hedging transaction entered into on or after the date § 1.954–2(f)(2)(v) is published as a final regulation in the* ***Federal Register***—(A) *In general*. The term *qualified hedging transaction* means a *bona fide* hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to one or more commodities transactions reasonably necessary to the conduct of any business by a producer, processor, merchant or handler of commodities in a manner in which such business is customarily and usually conducted by others. For purposes of this paragraph (f)(2)(v), a producer, processor, merchant or handler of commodities includes a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business.

(B) *Exception*. The term *qualified hedging transaction* does not include a transaction described in section 988(c)(1) (without regard to section 988(c)(1)(D)(i)).

(C) *Examples*. The following examples illustrate the provisions of this paragraph (f)(2)(v):

Example 1. CFC1 is a controlled foreign corporation located in country A. CFC1 manufactures and sells machinery in country B using aluminum and component parts purchased from third parties that contain significant amounts of aluminum. CFC1 conducts its manufacturing business in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aluminum used in the machinery it manufactures, CFC1 enters into futures purchase contracts for the delivery of aluminum. These futures purchase contracts are *bona fide* hedging transactions. As CFC1 purchases aluminum and component parts containing significant amounts of aluminum in the spot market for use in its business, it closes out an equivalent amount of aluminum futures purchase contracts by entering into offsetting aluminum futures sales contracts. The aluminum futures purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aluminum futures purchase contracts is excluded from the computation of foreign personal holding company income.

Example 2. CFC2 is a controlled foreign corporation located in country B. CFC2 operates an airline business within country B in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aviation fuel, CFC2 enters into forward contracts for the purchase of aviation fuel. These forward purchase contracts are *bona fide* hedging transactions. As CFC2 purchases aviation fuel in the spot market for use in its business, it closes out an equivalent amount of its forward purchase contracts for cash pursuant to a contractual provision that permits CFC2 to terminate the contract and make or receive a one-time payment representing the contract's fair market value. The aviation fuel forward purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aviation fuel forward purchase contracts is excluded from the computation of foreign personal holding company income.

(D) *Effective date*. This paragraph (f)(2)(v) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into on or after the date § 1.954–2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(vi) *Financial institutions not a producer, etc*. For purposes of this paragraph (f), a corporation is not a producer, processor, merchant or handler of commodities if its business is primarily financial. For example, the business of a controlled foreign corporation is primarily financial if its principal business is making a market in notional principal contracts based on a commodities index.

* * * * *

(g) * * *

(2) * * *

(ii) * * *

(C) *Regular dealers*—(*1*) *General rule*. Transactions in dealer property (as defined in paragraph (a)(4)(v) of this section) described in section 988(c)(1)(B) or (C) that are entered into by a controlled foreign corporation that is a regular dealer (as defined in paragraph (a)(4)(iv) of this section) in such property in its capacity as

a dealer will be treated as directly related to the business needs of the controlled foreign corporation under paragraph (g)(2)(ii)(A) of this section.

(2) *Certain interest-bearing liabilities treated as dealer property*—(*i*) *In general*. For purposes of this paragraph (g)(2)(ii)(C), an interest-bearing liability incurred by a controlled foreign corporation that is denominated in (or determined by reference to) a non-functional currency shall be treated as dealer property if the liability, by being denominated in such currency, reduces the controlled foreign corporation's currency risk with respect to dealer property, and the liability is identified on the controlled foreign corporation's records as a liability treated as dealer property before the close of the day on which the liability is incurred.

(*ii*) *Failure to identify certain liabilities*. If a controlled foreign corporation identifies certain interest-bearing liabilities as liabilities treated as dealer property under the previous paragraph but fails to so identify other interest-bearing liabilities that manage its currency risk with respect to assets held that constitute dealer property, the Commissioner may treat such other liabilities as dealer property if the Commissioner determines that the failure to identify such other liabilities had as one of its principal purposes the avoidance of federal income tax.

(*iii*) *Effective date*. This paragraph (g)(2)(ii)(C)(*2*) applies only to gain or loss from an interest-bearing liability entered into by a controlled foreign corporation on or after the date § 1.954–2(g)(2)(ii)(C)(*2*) is published as a final regulation in the **Federal Register**.

* * * * *

(iii) *Special rule for foreign currency gain or loss from an interest-bearing liability*. Except as provided in paragraph (g)(2)(ii)(C)(*2*) or (g)(5)(iv) of this section, foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under §§ 1.861–9T and 1.861–12T.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 10, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 13, 2002, 67 F.R. 31995)

Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2002–51

The name of an organization that no longer qualifies as an organization described in section 170(c)(2) of the Internal Revenue Code of 1986 is listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on March 18, 2002, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428 (c)(1). For individual contributors, the maximum deduction protected is $1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Crisis at Home Intervention Center
San Bruno, CA

Changes in Annual Accounting Period

Announcement 2002–53

PURPOSE

This announcement discusses some of the more significant issues raised in connection with finalizing Notice 2001–34, 2001–23 I.R.B. 1302, and Notice 2001–35, 2001–23 I.R.B. 1314, which proposed procedures for obtaining the Commissioner's approval to adopt, change, or retain an annual accounting period under §§ 441 and 442 of the Internal Revenue Code and the regulations thereunder.

BACKGROUND

Notice 2001–34 proposed procedures for obtaining the Commissioner's prior approval to adopt, change, or retain an annual accounting period, applicable to a taxpayer that is not within the scope of any automatic approval procedure. Notice 2001–35 proposed new automatic approval procedures for partnerships, S corporations, electing S corporations, and personal service corporations (PSCs). Both notices requested comments from the public in connection with the proposed procedures. At the same time that the Service published these notices, it also issued new proposed regulations (REG–106917–99, 2001–27 I.R.B. 4) under §§ 441, 442, 706, and 1378, relating to annual accounting periods, which also requested public comments.

Rev. Proc. 2002–39, finalizing Notice 2001–34, and Rev. Proc 2002–38, finalizing Notice 2001–35, appear elsewhere in this Bulletin, along with Rev. Proc. 2002–37, which provides updated automatic approval procedures for corporations. These revenue procedures, together with final regulations (T.D. 8996, published in the May 17, 2002, Federal Register (67 FR 35009)) under §§ 441, 442, 706, and 1378, issued concurrently, are intended to provide comprehensive guidance on the adoption, change, and retention of an

annual accounting period. The most significant comments received in connection with Notice 2001–34 and Notice 2001–35, along with certain other changes to the proposed procedures, are discussed below. Comments specific to the proposed regulations are discussed in the preamble to the final regulations.

CHANGES TO NOTICE 2001–34 (PRIOR APPROVAL PROCEDURES)

A. *Natural Business Year*

One commentator suggested that the final revenue procedure clarify the terms "peak and nonpeak periods," "at or soon after," and "insignificant gross receipts," in connection with the annual business cycle and seasonal business tests. Rev. Proc. 2002–39 provides clarification by including safe harbor rules for administrative convenience, as well as examples. One safe harbor provides that 1 month will be deemed to be "soon after" the end of a peak period (in the case of the annual business cycle test) or the close of operations (in the case of the seasonal business test). Under a second safe harbor, gross receipts will be deemed to be "insignificant" for purposes of the seasonal business test if they are less than 10 percent of the taxpayer's total gross receipts for the year. The examples illustrate the application of these safe harbor rules. Taxpayers that do not meet the safe harbor rules nevertheless may establish that their requested taxable year meets the annual business cycle test or seasonal business test using all of the facts and circumstances.

Notice 2001–34 provided that a taxpayer seeking to establish a natural business year under section 5.03 must provide information about its gross receipts for the three taxable years immediately preceding the first effective year. Although Rev. Proc. 2002–39 continues to require this information, and to require that the annual business cycle, seasonal business, or 25-percent gross receipts test be met for each of the three preceding years for taxpayers that have been in existence for that length of time, the Service and Treasury realize that newly formed taxpayers may be uncertain about whether and how they can establish a natural business year under these tests. Accordingly, Rev. Proc. 2002–39 clarifies that a taxpayer that has not been in existence for 3 taxable years may satisfy the annual business cycle or seasonal business test by providing information other than prior years' gross receipts, such as a description of its business and reasonable estimates of its gross receipts. However, the Service and Treasury believe that the more objective 25-percent gross receipts test should continue to apply only to established taxpayers that can produce actual gross receipts information for the required 3-year period.

B. *Additional Acceptable Business Purposes*

Section 5.02(1)(b) of Notice 2001–34 provides that a taxpayer, including a partnership, S corporation, electing S corporation, or PSC, may establish a business purpose for a requested taxable year for purposes of section 5.02(1) (to which only general terms and conditions apply) based on all of the facts and circumstances. A commentator requested that the Service provide examples of the kinds of facts and circumstances that would be sufficient for a taxpayer to demonstrate a sufficient business purpose. The commentator further suggested that the final revenue procedure explain whether and how facts such as a taxpayer's gross receipts would be evaluated to determine whether the taxpayer has demonstrated a sufficient business purpose under the facts and circumstances test of section 5.02(1)(b). The Service and Treasury intend for the facts and circumstances test of section 5.02(1)(b) to apply only in rare and unusual circumstances. Rev. Proc. 2002–39 has been clarified to that effect. Accordingly, examples such as those suggested by the commentator have not been included in Rev. Proc. 2002–39.

It should be noted that, if a taxpayer (other than a taxpayer with a required taxable year) fails to satisfy one of the three alternative tests for showing a natural business year (annual business cycle, seasonal business, or 25-percent gross receipts), then the taxpayer still may obtain approval for the change if it demonstrates some nontax reason for the change and accepts additional terms and conditions that are necessary to eliminate substantial distortion created by the change. Under Rev. Proc. 2002–39, this nontax reason can be a reason not heretofore accepted by the Service as a sufficient business purpose in cases where substantial distortion is present, and can be based on criteria, such as gross receipts, that are also the focus of the natural business year tests. For example, such a business purpose could include having significant gross receipts in the last months of the requested taxable year, albeit less than 25 percent of the taxpayer's annual gross receipts.

C. *Changes Within 48 Months*

Some taxpayers have expressed concern that the Service will deny most, or even all, applications to change or retain an annual accounting period under the final prior approval procedures if the taxpayer made a change within the previous 48 months ("prior change"). Although a prior change may disqualify a taxpayer for automatic approval of a change or retention, the Service expects that, for the vast majority of applications under Rev. Proc. 2002–39, approval will not be denied because of a prior change. However, in certain cases, approval may be denied because of the taxpayer's accounting period history (for example, where there exists a pattern of prior changes). *See generally* section 7.01 of Rev. Proc. 2002–39.

D. *Director Consent/Audit Protection*

Notice 2001–34 proposed to offer audit protection to all taxpayers that received prior approval under the final revenue procedure to retain or change an annual accounting period. Consistent with procedures of the Service in the accounting method area, taxpayers under examination were required to secure the consent of the Director to the change or retention. One commentator argued that the requirement to obtain the Director's consent was burdensome, particularly for corporate taxpayers for whom an annual accounting period ordinarily would not be an issue under consideration. The commentator suggested either that all taxpayers under examination be permitted to provide a representation (under penalties of perjury) that their annual accounting period is not an issue under consideration, in lieu of a letter of consent from the Director, or that audit protection be limited to taxpayers that provide the letter of consent.

After carefully weighing the benefits of audit protection against the burden of obtaining the requisite Director consent, the Service and Treasury Department have determined that it is appropriate to extend audit protection only to certain taxpayers with required taxable years, namely, partnerships, S corporations, electing S corporations, and PSCs. Accordingly, other corporate taxpayers, and taxpayers with required taxable years other than those identified above, that are under examination or before an area office or a federal court will not be required to obtain Director consent as a prerequisite to applying for a change under Rev. Proc. 2002–39, and will not be offered audit protection. Similarly, no consent letter is required, and no audit protection is offered, by Rev. Proc. 2002–37, which provides automatic consent procedures for corporations.

E. *Failure to Satisfy Natural Business Year Test in Future Years*

Notice 2001–34 provides that if a partnership, S corporation, electing S corporation, or PSC changes to a natural business year, and that year later fails to qualify as a permitted year, the taxpayer must then change to a permitted year. One commentator objected to this condition, arguing that it effectively mandates annual monitoring of the taxpayer's continued compliance with the natural business year requirement, and as such is overly burdensome. The commentator suggested that the final procedures instead adopt a 3-year testing period.

The Service and Treasury Department believe that a 3-year testing period is inconsistent with the statutory framework imposing required years on such taxpayers, and that the taxpayer's year must continue to be a permitted year in order for the taxpayer to retain it. It should be noted, however, that even if the requested taxable year fails in some later year to qualify as a permitted year under the original test for which approval was granted (for example, the 25-percent gross receipts test), the taxpayer need not change its existing taxable year if the taxpayer can demonstrate that the year is a permitted year under some other test (for example, the annual business cycle test). The same would be true for a taxpayer that changed to or retained a natural business year under one of the automatic approval revenue procedures.

F. *Substantial Distortion of Income*

Notice 2001–34 provides that, for purposes of determining whether the additional terms and conditions of section 5.05 apply, distortion of income resulting from the requested taxable year change will not be considered substantial if the amount of the distortion is less than both: (1) 5 percent of the taxpayer's estimated gross receipts for its current taxable year; and (2) $500,000. The amount of the distortion or deferral is the taxpayer's allocable share of income from a pass-through entity, including ordinary income or loss, rents, royalties, interest, dividends, and deduction equivalents of credits. A similar *de minimis* rule is provided in Rev. Proc. 2000–11 (applied to each of the 3 prior taxable years) for determining whether a corporation with an interest in a pass-through entity is within the scope of that automatic approval revenue procedure.

One commentator suggested that the final prior approval procedures eliminate the $500,000 floor. The commentator believes that, in the case of prior approval applications processed by the national office, it is more appropriate for the Service to determine on a case-by-case basis whether an estimated amount of distortion is *de minimis*.

The Service and Treasury Department believe that the $500,000 floor is appropriate in order to promote consistency of results and facilitate the administration of prior approval applications. Thus, the $500,000 floor is retained in Rev. Proc. 2002–39. Similarly, the $500,000 floor contained in Rev. Proc. 2000–11 is retained in Rev. Proc. 2002–37.

The commentator also recommended that, regardless of the *de minimis* distortion test, the additional terms and conditions of section 5.05 of Notice 2001–34 not apply if the taxpayer's interest in the pass-through entity is less than 5 percent of the entity's profits and capital. The Service and Treasury do not believe that such a rule would be appropriate, as even a 1 percent interest in profits and capital can potentially result in a significant amount of distortion.

CHANGES TO NOTICE 2001–35 (AUTOMATIC APPROVAL PROCEDURES FOR PASS-THROUGH ENTITIES)

A. *Natural Business Year*

One commentator suggested that the final procedures for obtaining automatic approval by a pass-through entity clarify whether a taxpayer changing to or from a 52–53-week taxable year ending with reference to its existing natural business year is required to recompute the 25-percent gross receipts test. Section 7.02(6) of Rev. Proc. 2002–38 requires only a taxpayer changing to a natural business year using the 25-percent gross receipts test to provide the gross receipts information with its application, in compliance with the instructions for Form 1128, *Application to Adopt, Change, or Retain a Tax Year*. A taxpayer changing to or from a 52–53-week taxable year ending with reference to its existing natural business year is not required to provide this information. However, as discussed above, for a taxpayer with a required year to continue to use a fiscal year, that year must continue to be a permitted year.

B. *Ownership Taxable Year*

Notice 2001–35 provided that, for purposes of determining the ownership tax year of an S corporation or electing S corporation, a shareholder that is tax-exempt under § 501(a) is disregarded if such shareholder is not subject to tax on any income attributable to the S corporation. One commentator suggested that tax-exempt shareholders should not be disregarded if the S corporation is wholly owned by such shareholders. This suggestion has been adopted in Rev. Proc. 2002–38.

C. *Certain Minor Changes in Ownership of Partnerships*

To alleviate taxpayer burden associated with temporary and minor changes in ownership of a partnership that result in a new required year under § 706(b), a new rule has been added to Rev. Proc. 2002–38. The rule provides that a partnership required under § 706(b) to change its taxable year due to a change of less than 10 percent of the aggregate interests of all

partners in the partnership's profits and capital may continue to use its current taxable year for one taxable year if it is foreseeable that the change in ownership will be reversed after one taxable year.

CHANGES TO REV. PROC. 2000–11

A. *Automatic Changes to Natural Business Year*

Rev. Proc. 2000–11 did not allow corporations with disqualifying interests in pass-through entities to change automatically to a natural business year under the 25-percent gross receipts test. Under the final prior approval procedures of Rev. Proc. 2002–39, a corporation qualifying to change to a natural business year based on the 25-percent gross receipts test generally would receive approval to do so (subject only to general terms and conditions) notwithstanding any resulting deferral or distortion attributable to an interest in a pass-through entity. Accordingly, the Service and Treasury Department believe that it is appropriate to provide automatic approval for corporations to change to a natural business year, based on the 25-percent gross receipts test, notwithstanding their interest in a pass-through entity. Rev. Proc. 2002–37 reflects this change.

B. *Conforming Changes*

Certain conforming changes have been made to Rev. Proc. 2002–37, consistent with the rules set forth in the final regulations, Rev. Proc. 2002–38, and Rev. Proc. 2002–39. For example, the limitation on changes within 6 years has been reduced to the most recent 48 months, corporations that are shareholders of a closely-held real estate investment trust are considered to have an interest in a pass-through entity for purposes of the scope limitations of Rev. Proc. 2002–37, and certain scope limitations are waived for changes to (or from) certain 52–53-week taxable years that reference the same calendar month. In addition, Rev. Proc. 2002–37 has been modified to provide that a *de minimis* interest in a controlled foreign corporation, foreign personal holding company, or passive foreign investment company may be disregarded under section 4 of that revenue procedure for purposes of determining whether a corporation is within the scope of Rev. Proc. 2002–37, similar to the treatment of *de minimis* interests in partnerships.

FURTHER INFORMATION

For further information regarding this announcement, contact Martin Scully, Jr. or Michael F. Schmit of the Office of the Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4960 (not a toll-free call).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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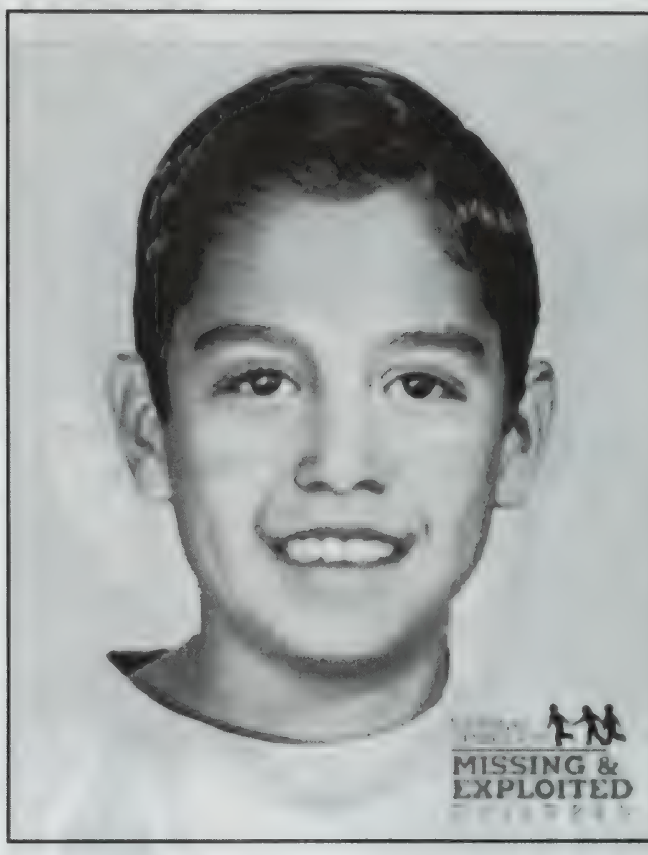

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2002-23

Internal Revenue bulletin

Bulletin No. 2002–23
June 10, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 8994, page 1078.
Final regulations under sections 444, 641, 1361, 1362, and 1377 of the Code relate to the qualification and taxation of electing small business trusts (ESBTs), and to the definition of deferral entities for purposes of electing a taxable year other than the required taxable year. Notices 97–12 and 97–49 and Rev. Proc. 98–23 superseded.

T.D. 8995, page 1070.
Final regulations under section 460 of the Code provide rules applicable when there is a mid-contract change in the taxpayer accounting for a long-term contract that has been under a long-term contract method of accounting.

Notice 2002–37, page 1095.
This notice announces that regulations will be issued addressing partnership transactions involving contracts accounted for under a long-term contract method of accounting.

EMPLOYEE PLANS

Rev. Rul. 2002–32, page 1069.
Cafeteria plans. In an asset sale, transferred employees who have elected to participate in health flexible spending arrangements (FSAs) under the seller's cafeteria plan may continue to exclude salary reduction amounts and medical reimbursements from gross income without interruption at the same level of coverage after becoming employees of the buyer.

REG–105885–99, page 1103.
Proposed regulations under section 457 of the Code would provide guidance on compensation deferred under eligible section 457 deferred compensation plans of state and local governmental employers and tax-exempt entities. The regulations reflect changes made to section 457 by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, the Economic Growth and Tax Relief Reconciliation Act of 2001, and other legislation. These regulations would also make various technical changes and clarifications to the existing final regulations. A public hearing is scheduled for August 28, 2002.

EMPLOYMENT TAX

Rev. Rul. 2002–35, page 1067.
Wages subject to federal employment tax. This ruling clarifies that payments to employees for equipment they are required to provide as a condition of employment are wages for federal employment tax purposes, unless paid under an accountable plan. Rev. Rul. 68–624 revoked.

Rev. Proc. 2002–41, page 1098.
This procedure provides that employers in the pipeline construction industry may use an optional expense substantiation rule to provide reimbursements under an accountable plan to employees who also furnish welding rigs or mechanics rigs as a condition of employment and use those rigs in their performance of services as employees.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

Rev. Proc. 2002–40, page 1096.

Net operating losses; 5-year carryback. This document provides procedures that certain taxpayers with net operating losses incurred in 2001 or 2002 must follow on or before October 31, 2002, for applying or electing out of the new 5-year carryback period enacted by the Job Creation and Worker Assistance Act of 2002.

Announcement 2002–55, page 1125.

This document contains corrections to final regulations (T.D. 8985, 2002–14 I.R.B. 707) relating to the character of gain or loss from hedging transactions.

Announcement 2002–56, page 1126.

The Service announces that an updated edition of Publication 597, *Information on the U.S. – Canada Income Tax Treaty* (revised May 2002), is now available.

Announcement 2002–57, page 1126.

The Service announces that an updated edition of Publication 1544, *Reporting Cash Payments of Over $10,000* (revised March 2002), is now available. The Spanish version of this publication, Publication 1544SP, *Informe de Pagos en Efectivo en Exceso de $10,000* (revised April 2002), is also available.

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Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Section 62.—Adjusted Gross Income Defined

(Also §§ 3121(a), 3306(b), 3401(a), 7805(b).)
26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.
(Also §§ 31.3121(a), 31.3306(b), 31.3401(a), 301.7805–1.)

Wages subject to federal employment tax. This ruling clarifies that payments to employees for equipment they are required to provide as a condition of employment are wages for federal employment tax purposes, unless paid under an accountable plan.

Rev. Rul. 2002–35

ISSUE

Whether amounts paid to employees for employee-provided equipment, including vehicles, that are used by the employee to provide services as an employee are wages subject to federal employment taxes?

FACTS

Situation 1 — Business *A* is engaged in pipeline construction and repair. *A* hires welder *B* and heavy equipment mechanic *C* to perform services as employees in connection with the construction of a pipeline. Business *A* requires *B* to provide and maintain a welding rig for *B*'s use in providing welding services and requires *C* to provide and maintain a mechanics rig for *C*'s use in performing repair and maintenance services at the work site on the employer's heavy equipment. *B* and *C* are required to provide rigs sufficient to perform the required employee services. (Neither employee *B* nor *C* is an independent contractor.)

A welding rig consists of a truck equipped with a welding machine and other specialized welding equipment required to perform welding services. *B* is paid an hourly wage of $X for the performance of services as an employee. In addition, *A* pays *B* an hourly amount of $Y per hour for providing the welding rig. This rig reimbursement is only paid for those hours that *B* performs services as *A*'s employee.

A mechanics rig consists of a heavy truck equipped with a crane, welding machine, and various other equipment used in the repair of heavy construction equipment. *C* is paid an hourly wage of $X for the performance of services as an employee. In addition *A* pays *C* an additional $Y amount per day for providing the mechanics rig. This rig reimbursement is only paid for the days that *C* performs services as *A*'s employee.

Business *A* requires *B* and *C* to each execute a document specifying that the employee owns the rig provided and will insure and maintain the rig. Employees *B* and *C* bear all expenses associated with the operation and maintenance of their respective rigs. The flat dollar amount paid as rig reimbursement is not related to the actual employee business expenses *B* or *C* incurs while performing services as an employee of *A*. Business *A* does not require *B* or *C* to substantiate expenses incurred related to the rig provided. Nor does *A* require *B* or *C* to return any amount paid as a rig reimbursement that exceeds the actual employee business expenses *B* or *C* incurs in connection with providing a rig while performing services as an employee of *A*.

Situation 2 — Business *A* also hires laborer *D* to perform services as an employee. Employee *D* uses *D*'s pickup truck for transportation along the pipeline. Employee *D* is paid an hourly wage of $X for the performance of services as an employee and is also paid an additional amount of $Y per day for providing the pickup truck. Business *A* does not require *D* to substantiate mileage or actual employee business expenses incurred while performing services as an employee of *A*. Employee *D* is not required to return any of the daily amounts paid for the pickup truck if the amount paid exceeds the employee business expenses *D* incurred in connection with the pickup truck while performing services as an employee of *A*. (Laborer *D* is not an independent contractor.)

LAW AND ANALYSIS

Section 3402(a) of the Internal Revenue Code (Code) requires employers paying wages to deduct and withhold income tax on wages. For income tax withholding purposes, § 3401(a) provides that the term "wages," with certain exceptions, means all remuneration for services performed by an employee for an employer. Under §§ 3111 and 3301, Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax, respectively, excise taxes are imposed on the employer in an amount equal to a percentage of the wages paid by that employer. Under § 3101, FICA tax also is imposed on the employee. Under §§ 3121(a) and 3306(b), the term "wages" for FICA tax purposes and FUTA tax purposes, respectively, means, with certain exceptions, all remuneration for employment. Under §§ 3121(b) and 3306(c), "employment" is defined as any service, of whatever nature, performed by an employee for the person employing him.

Consistent with this definition, § 31.3121(a)–1(c) of the Employment Tax Regulations provides that the name by which the remuneration for employment is designated is immaterial. Section 31.3121(a)–1(d) further provides that generally, the basis upon which remuneration is paid to an employee is immaterial in determining whether the remuneration constitutes wages under FICA.

No specific section of the Code or regulations excepts from wages amounts paid to employees for providing equipment used in the performance of services as an employee. However, amounts paid to employees for certain employee business expenses incurred in connection with such equipment are excluded from wages if paid under a reimbursement or other expense allowance arrangement that meets the requirements of § 62(c).

Under § 1.62–2(c)(1) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements set forth in paragraphs (d), (e), and (f) of § 1.62–2 (business connection, substantiation, and return of excess). If an arrangement meets

these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. § 1.62–2(c)(2)(i). Amounts paid under an accountable plan are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. §§ 31.3121(a)–3, 31.3306(b)–2, 31.3401(a)–4, and 1.6041–3(h)(1).

If an arrangement does not satisfy one or more of these requirements, all amounts paid under the arrangement are paid under a "nonaccountable plan." Amounts paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes. §§ 1.62–2(c)(5), 31.3121(a)–3(b)(2), 31.3306(b)–2(b)(2), 31.3401(a)–4(b)(2), and § 1.6041–3(h)(1). Additionally, § 1.62–2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments made under the arrangement will be treated as made under a nonaccountable plan.

Rev. Rul. 68–624, 1968–2 C.B. 424, considered what portion of the total amount paid by a corporation for the use of a truck and the services of a driver was allocable as wages of the driver for federal employment tax purposes. The driver hauled stone from the corporation's quarry to its river loading dock at a fixed amount per load. The corporation allocated one-third of the amount paid to the employee as wages and two-thirds as payment for the use of the truck. The ruling held that an allocation of the amounts paid to an individual when the payment is for both personal services and the use of equipment must be governed by the facts in each case. If the contract of employment did not specify a reasonable division of the total amount paid between wages and equipment, a proper allocation could have been arrived at by reference to the prevailing wage scale in a particular locality for similar services in operating the same class of equipment or the fair rental value of similar equipment.

Rev. Rul. 68–624 pre-dates the Tax Reform Act of 1986 (TRA '86), Pub. L. 99–514, and the Family Support Act of 1988, Pub. L. 100–485, which limit the deductions of employee business expenses. Pursuant to section 132 of TRA '86, which added § 67 to the Code, employee business expenses are allowed only as miscellaneous itemized deductions, to the extent that the aggregate of those deductions exceeds 2 percent of adjusted gross income. Section 62(c), which was enacted in the Family Support Act of 1988, in part limits employee business expense reimbursements that can be excluded from adjusted gross income to those paid under an accountable plan. Further, Rev. Rul. 68–624 does not address whether the truck driver was engaged in the trade or business of truck rental in addition to the trade or business of being an employee.

An arrangement that merely allocates compensation paid to an employee between wages and a reimbursement for business expenses will not meet the requirements of § 62(c). For example, in *Shotgun Delivery, Inc. v. United States*, 269 F.3d 969 (9th Cir. 2001), the court held that a courier company's arrangement that paid employee drivers 40 percent of the delivery charge rate less an hourly minimum wage payment did not meet the business connection requirement because the drivers were reimbursed regardless of actual mileage driven or expenses incurred. Accordingly, the arrangement was not a valid accountable plan under § 62(c).

CONCLUSION

Under the facts specified in Situations 1 and 2, the amounts paid to employees *B*, *C*, and *D* for providing equipment, including vehicles, used in performing services for the employer as an employee are not paid under an accountable plan. Each arrangement fails the business connection requirement because in each situation the employer pays an amount to the employee regardless of whether the employee incurs (or is reasonably expected to incur) business expenses that would be deductible under §§ 161 through 198. Each arrangement fails to require the employee to substantiate employee business expenses, as required by § 1.62–2(e). Finally, the arrangements do not require the return of excess as required under § 1.62–2(f).

HOLDING

In Situations 1 and 2, because the amounts paid to the employee for providing equipment, including vehicles, for use in performing services as an employee are not paid under an accountable plan, they are wages subject to the withholding and payment of income and employment taxes.

This ruling is not intended to provide guidance regarding the treatment of payment for equipment, including vehicles, provided by independent contractors.

See Rev. Proc. 2002–41, published elsewhere in this Internal Revenue Bulletin, regarding a deemed substantiation rule for use in implementing an accountable plan in connection with reimbursements to certain employees for costs associated with providing welding rigs or mechanics rigs.

EFFECT ON OTHER REVENUE RULINGS

This ruling revokes Rev. Rul. 68–624.

EFFECTIVE DATE

This revenue ruling is effective for payments to employees after October 13, 1988 (the date of enactment for § 62(c), as part of the Family Support Act of 1988).

Under the authority of § 7805(b), a taxpayer that actually paid amounts separate from wages for the use of employee-provided equipment (such as described in Situation 1 and the truck described in Rev. Rul. 68–624) and reported these payments on timely issued Forms 1099 for calendar years beginning before January 1, 2002, may continue to report these payments on Form 1099 for periods ending on or before December 31, 2002.

DRAFTING INFORMATION

The principal author of this revenue ruling is Joe Spires of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue ruling, call Mr. Spires at (202) 622–6040 (not a toll-free number).

Section 125.—Cafeteria Plans

(Also sections 106, 4980B.)

Cafeteria Plans. In an asset sale, transferred employees who have elected to participate in health flexible spending arrangements (FSAs) under the seller's cafeteria plan may continue to exclude salary reduction amounts and medical reimbursements from gross income without interruption at the same level of coverage after becoming employees of the buyer.

Rev. Rul. 2002–32

ISSUE

In an asset sale, may transferred employees who have elected to participate in health flexible spending arrangements (FSAs) under seller's I.R.C. § 125 cafeteria plan continue that benefit without interruption at the same level of coverage after becoming employees of buyer?

FACTS

Situation (1). Employer S maintains a cafeteria plan under section 125. One of the benefits available under the plan is a health FSA that provides for the reimbursement of participating employees' medical care expenses that are not covered by other insurance. To participate in the health FSA, employees elect pre-tax salary reduction for the right to receive medical care expense reimbursements during the plan year up to a maximum amount equal to the amount of the reduction elected for the year. Employer B is an unrelated business entity.

During a plan year, S and B enter into an agreement under which B acquires a portion of the assets of S and, as part of the acquisition, employees of S who work in connection with the acquired assets terminate employment with S and are transferred to and become employees of B. Employer B has, or agrees to create, a cafeteria plan that offers a health FSA through pre-tax salary reduction. It is the objective of both S and B that the administration of the transferred employees' health FSAs following the asset sale have as little impact on the transferred employees as possible. Following the sale, S will continue its business operations, including its health FSA. S and B agree that the transferred employees who have elected to participate in S's FSA will continue in S's FSA for the agreed upon period. S and B also agree on the extent, if any, to which the existing salary reduction elections made by the transferred employees for the FSAs under S's plan will continue as if made under B's plan.

Situation (2). Same facts as in Situation (1) except that, as part of the sale, B agrees to cover the transferred employees who have elected to participate in S's health FSA under B's health FSA. Under B's health FSA, the transferred employees will have the same level of coverage provided under S's health FSA and will be treated as if their participation had been continuous from the beginning of S's plan year. The transferred employees' existing salary reduction elections will be taken into account for the remainder of B's plan year as if made under B's health FSA. To implement this arrangement, B amends its plan documents to provide that transferred employees who elected to participate in S's health FSA become participants in B's health FSA as of the beginning of S's plan year and at the level of coverage provided under S's health FSA, except that transferred employees who continue participation in S's health FSA after the sale (*e.g.*, by election of COBRA continuation coverage) are not covered by B's health FSA for that year. In addition, B's health FSA is amended to provide for reimbursement of medical care expenses incurred by the transferred employees at any time during S's plan year (including claims incurred before the sale), up to the amount of the employees' election and reduced by amounts previously reimbursed by S. Thus, medical care expenses incurred prior to the closing date of the sale but not previously reimbursed as well as medical care expenses incurred after the closing date of the sale are reimbursable under B's health FSA. S amends its plan documents to provide that the transferred employees cease to be eligible for medical care expense reimbursements from S as of the closing date, except to the extent of any COBRA continuation coverage election. S and B have determined that the agreements between them are consistent with applicable law.

LAW AND ANALYSIS

In general, section 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under section 105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee during the period of coverage for medical care (of the employee, the employee's spouse, or the employee's dependents) for personal injuries or sickness.

Section 125(a) states that no amount will be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits in the plan.

Section 125(d) defines a cafeteria plan as a written benefit plan under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and certain qualified benefits.

Section 125(f) defines qualified benefits as any benefit not includible in the gross income of the employee by reason of an express provision of Chapter 1 of the Code other than certain specified benefits that are not qualified benefits. A qualified benefit includes employer-provided accident or health coverage under section 106(a) and reimbursements for medical care expenses under section 105(b).

Section 1.125–4 of the Income Tax Regulations provides the circumstances under which an employer can permit a cafeteria plan participant to change an existing election during a period of coverage and make a new election for the remaining portion of the period of coverage. Generally, cafeteria plan participants are permitted to make election changes if there has been a change in status event and the election change satisfies the consistency rule. An election change satisfies the consistency rule with respect to accident or health coverage only if the election change is on account of and corresponds with a change in status that affects eligibility for coverage under an employer's plan.

Under the asset sale described in both Situation (1), where transferred employees maintain their existing health FSAs under S's cafeteria plan, and in Situation (2), where B agrees to cover the transferred employees who have elected to participate in S's health FSA, there is no loss of eligibility for coverage under § 1.125–4. Therefore, transferred employees continue to be subject to their existing FSA elections and may not change those elections during the remainder of the plan year of the asset sale (unless an event occurs thereafter which permits an election change under § 1.125–4).

For COBRA purposes, transferred employees in Situation (1) do not suffer a loss of coverage under S's FSA during the plan year. Consequently, if S's FSA satisfies the requirements of Q&A-8(c) in § 54.4980B–2, there is no obligation to make COBRA continuation coverage available to the transferred employees with respect to their coverage under S's FSA. However, if S's FSA does not satisfy the requirements of Q&A-8(c) in § 54.4980B–2 and is otherwise subject to COBRA, then it will be obligated to make COBRA continuation coverage available beginning on the first day of the plan year after the current plan year. For additional information, see § 54.4980B–2, Q&A-8 and § 54.4980B–9. In Situation (2), the obligation of S to extend to COBRA qualified beneficiaries the right to elect COBRA continuation coverage is not affected by the coverage provided by B.

HOLDING

In an asset sale, transferred employees who have elected to participate in health FSAs under seller's cafeteria plan may continue to exclude the salary reduction amounts and medical expense reimbursements from gross income without interruption and at the same level of coverage after becoming employees of buyer either when seller agrees to continue its existing health FSAs for the transferred employees as described in Situation (1) or when buyer agrees to adopt a continuation of seller's health FSAs for the transferred employees as described in Situation (2).

EFFECT ON OTHER REVENUE RULING(S)

None

DRAFTING INFORMATION

The principal author of this revenue ruling is Shoshanna Chaiton of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact her at (202) 622–6080 (not a toll-free call).

Section 172.—Net Operating Loss Deduction

Procedures are provided that certain taxpayers with net operating losses incurred in 2001 or 2002 must follow on or before October 31, 2002, if they wish to apply, or elect out of, the new 5-year carryback period enacted by section 102 of the Job Creation and Worker Assistance Act of 2002. See Rev. Proc. 2002–40, page 1096.

Section 460.—Special Rules for Long-Term Contracts

26 CFR 1.460–4: Methods of accounting for long-term contracts.

T.D. 8995

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Mid-Contract Change in Taxpayer

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting. A taxpayer that is a party to such a contract will be affected by these regulations.

DATES: *Effective Date*: These regulations are effective May 15, 2002.

Applicability Date: These regulations apply to transactions on or after May 15, 2002.

FOR FURTHER INFORMATION CONTACT: John Aramburu at (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1732.

The collection of information in these final regulations is in § 1.460–6(g)(3)(ii)(D). This information is required to enable taxpayers to make look-back computations when the income from a long-term contract has been previously reported by another taxpayer.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

The estimated average annual disclosure burden per respondent is 2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 460 generally requires that long-term contracts be accounted for

under the percentage-of-completion method (PCM), under which a taxpayer must recognize income according to the estimated percentage of the contract that is completed during each taxable year and make a look-back computation of interest to compensate the government (or the taxpayer) for any underestimation (or overestimation) of income from the contract. However, home construction contracts and certain contracts of smaller construction contractors are exempt from these requirements. Moreover, residential builders are entitled to use the 70/30 percentage-of-completion/capitalized cost method (PCCM), and certain shipbuilders are entitled to use the 40/60 PCCM. A long-term contract or a portion of a long-term contract that is exempt from the PCM may be accounted for under any permissible method, including the completed contract method (CCM), under which a taxpayer does not report income until a contract is complete, even though progress payments are received in years prior to completion.

This document contains amendments to 26 CFR part 1. On February 16, 2001, a notice of proposed rulemaking (REG–105946–00, 2001–1 C.B. 1069) relating to a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting was published in the **Federal Register** (66 FR 10643). Written comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested or held. After consideration of all comments, the proposed regulations are adopted as amended by this Treasury decision.

Explanation and Summary of Comments

The proposed regulations divide the rules regarding a mid-contract change in taxpayer of a contract accounted for under a long-term contract method of accounting into two categories—constructive completion transactions and step-in-the-shoes transactions. Generally, a constructive completion transaction results in the taxpayer originally accounting for the long-term contract (old taxpayer) recognizing income from the contract based on a contract price that takes into account any amounts realized from the transaction or paid by the old taxpayer to the taxpayer subsequently accounting for the long-term contract (new taxpayer) that are allocable to the contract. Similarly, the new taxpayer in a constructive completion transaction is treated as though it entered into a new contract as of the date of the transaction, with the contract price taking into account the purchase price and any amount paid by the old taxpayer that is allocable to the contract. In the case of a step-in-the-shoes transaction, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. The new taxpayer must assume the old taxpayer's methods of accounting for the contract, with both the contract price and allocable contract costs based on amounts taken into account by both parties.

Commentators raised concerns regarding the general application of step-in-the-shoes treatment to contracts of S corporations accounted for using the CCM. For example, these commentators were concerned with the potential for income shifting that can occur when the stock of an S corporation that is accounting for a long-term contract using the CCM is sold to a party with a lower marginal tax rate or to a tax indifferent shareholder. Similarly, income from a CCM contract could be shifted to a party with a lower tax rate or a tax indifferent party by making an S election or transferring the contract in a section 351 transaction, followed by an S election and a sale of stock. To prevent such a shifting of income, these commentators generally recommend that the transferor be required to apply the PCM to CCM contracts in progress as of the transaction date.

While these commentators' concerns and recommendations relate solely to CCM contracts, the potential for such income shifting also exists with PCM contracts due to the fact that recognition of income under both the PCM and the CCM does not correspond to the receipt of progress payments. In addition, many of the commentators' concerns are not unique to the section 460 regulations as similar opportunities are presented whenever an S corporation or an electing S corporation has assets with built-in gain or loss. Moreover, adoption of the commentators' recommendation would trigger tax as of the transaction date and thus would be inconsistent with the policy of providing for tax-free reorganizations of going concerns. Thus, the commentators' proposals for addressing this potential abuse were not adopted. However, as in the proposed regulations, the final regulations contain an anti-abuse rule that is designed to prevent such income shifting.

Commentators suggested that for purposes of the section 1374 built-in gain rules applicable to S corporation elections, long-term contracts should be valued at the amount of income reportable under the PCM on the date of the election. The section 1374 regulations currently measure recognized built-in gain attributable to a long-term contract accounted for using the CCM based on the amount of income reportable under the PCM on the date of the election. See § 1.1374–4(g). These final regulations, however, do not provide a specific rule to determine the value of a long-term contract because the fair market value of a long-term contract reflects a variety of factors, including the amount earned by the old taxpayer as compared to the progress payments received and retained by the old taxpayer, and the new taxpayer's estimates of future revenues and costs.

One commentator pointed out that while the preamble indicates the treatment of partnership transactions (*i.e.*, transactions described in sections 721 and 731, and transfers of partnership interests) have been reserved, the proposed regulations, by default, place these transactions in the taxable, constructive completion category. This commentator suggested that the regulations reserve the treatment of partnership transactions and provide only that taxpayers use reasonable methods.

The final regulations provide that a contribution to a partnership in a transaction described in section 721(a), a transfer of a partnership interest, and a distribution by a partnership to which section 731 applies (other than a distribution of a contract accounted for using a long-term contract method of accounting) are step-in-the-shoes transactions. The final regulations, however, reserve on the special rules that will apply to such transfers. As described in Notice 2002–37, 2002–23 I.R.B. 1030, the IRS and Treasury Department intend to publish regulations

that will set forth the special rules that will apply to such partnership transactions in a separate project. These regulations will be effective for contributions of long-term contracts to partnerships and transfers of interests in partnerships that are engaged in long-term contracts on or after May 15, 2002.

One commentator objected to the required use of the simplified marginal impact method of computing look back interest in the case of a step-in-the-shoes transaction. In response to this comment, the final regulations give taxpayers the option of using this method without requiring it, except in those cases in which the existing regulations require its use. See § 1.460–6(d)(4).

Questions have arisen as to whether the implementation of these rules requires a taxpayer to request a change in method of accounting by filing a Form 3115, "*Application for Change in Accounting Method.*" In response to these questions, the final regulations clarify that the application of these rules to a transaction occurring after the effective date is not a change in method of accounting and, therefore, does not require the filing of Form 3115.

In addition to changes made in response to the comments and questions described above, the final regulations clarify the application of the step-in-the-shoes rules to certain transfers of contracts that result in the old taxpayer recognizing income with respect to the contract. Specifically, the final regulations explain how the old taxpayer calculates the gain realized with respect to the contract in these transactions, clarify the operation of the basis adjustment rule in certain cases of successive transfers of a contract, and provide that the contract price of a new taxpayer should be reduced to the extent that the old taxpayer recognizes income with respect to the contract in connection with these transactions. The final regulations also clarify that a taxpayer is not entitled to a loss in the amount of its basis in the contract (including the uncompleted property, if applicable) where that basis is determined under section 362 or 334. In addition, to the extent the basis of the contract (including the uncompleted property, if applicable) reflects the old taxpayer's recognition of income attributable to the contract in the step-in-the-shoes transaction, such income recognition reduces the total contract price. Accordingly, the new taxpayer recovers this additional basis over the time that it performs the contract. To the extent the basis of the contract (including the uncompleted property, if applicable) reflects costs incurred by the old taxpayer that have not yet been deducted (*i.e.*, in the case of a CCM contract), such costs will give rise to a deduction upon completion of the contract. Therefore, disallowing the new taxpayer a loss for its basis in the contract (including the uncompleted property, if applicable) is necessary to prevent the new taxpayer from benefitting twice from the same item. Finally, the final regulations include new examples to illustrate these rules.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in this Treasury decision will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the relevant information is already maintained by taxpayers. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is John Aramburu, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.358–1, a sentence is added at the end of paragraph (a) to read as follows:

§ 1.358–1 Basis to distributees.

(a) * * * See § 1.460–4(k)(3)(iv)(A) for rules relating to stock basis adjustments required where a contract accounted for using a long-term contract method of accounting is transferred in a transaction described in section 351 or a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met.

* * * * *

Par. 3. In § 1.334–1, a sentence is added at the end of paragraph (b) to read as follows:

§ 1.334–1 Basis of property received in liquidations.

* * * * *

(b) * * * See § 1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of certain contracts accounted for using a long-term contract method of accounting that are acquired in certain liquidations described in section 332.

* * * * *

Par. 4. In § 1.362–1, a sentence is added at the end of paragraph (a) to read as follows:

§ 1.362–1 Basis to corporations.

(a) * * * See § 1.460–4(k)(3)(iv)(B)(*2*) for rules relating to adjustments to the basis of certain contracts accounted for using a long-term contract method of accounting that are acquired in certain transfers described in section 351 and certain reorganizations described in section 368(a).

* * * * *

Par. 5. In § 1.381(c)(4)–1, a sentence is added at the end of paragraph (a)(2) to read as follows:

§ 1.381(c)(4)–1 Method of accounting.

(a) * * *

(2) * * *See § 1.460–4(k) for rules relating to transfers of contracts accounted for using a long-term contract method of accounting in a transaction to which section 381 applies.

* * * * *

Par. 6. Section 1.460–0 is amended by:

1. Revising the entry for paragraph (k) of § 1.460–4.

2. Adding entries for paragraphs (k)(1) through (k)(6) of § 1.460–4.

3. Adding entries for paragraphs (g) through (g)(4) of § 1.460–6.

§ 1.460–0 Outline of regulations under section 460.

* * * * *

§ 1.460–4 Methods of accounting for long-term contracts.

* * * * *

(k) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(i) Scope.
(ii) Old taxpayer.
(iii) New taxpayer.
(iv) Special rules relating to distributions of certain contracts by a partnership. [Reserved.]
(3) Step-in-the-shoes transactions.
(i) Scope.
(ii) Old taxpayer.
(A) In general.
(B) Gain realized on the transaction.
(iii) New taxpayer.
(A) Method of accounting.
(B) Contract price.
(C) Contract costs.
(iv) Special rules related to certain corporate transactions.
(A) Old taxpayer — basis adjustment.
(*1*) In general.
(*2*) Basis adjustment in excess of stock basis.
(*3*) Subsequent dispositions of certain contracts.
(B) New taxpayer.
(*1*) Contract price adjustment.
(*2*) Basis in contract.
(v) Special rules related to certain partnership transactions. [Reserved.]
(4) Anti-abuse rule.
(5) Examples.
(6) Effective date.

* * * * *

§ 1.460–6 Look-back method.

* * * * *

(g) Mid-contract change in taxpayer.
(1) In general.
(2) Constructive completion transactions.
(3) Step-in-the-shoes transactions.
(i) General rules.
(ii) Application of look-back method to pre-transaction period.
(A) Contract Price
(B) Method.
(C) Interest accrual period.
(D) Information old taxpayer must provide.
(iii) Application of look-back method to post-transaction years.
(iv) S corporation elections.
(4) Effective date.

* * * * *

Par. 7. Section 1.460–4 is amended by:

1. Adding a sentence at the end of paragraph (a).

2. Adding paragraph (k).

The additions read as follows:

§ 1.460–4 Methods of accounting for long-term contracts.

(a) * * * Finally, paragraph (k) of this section provides rules relating to a mid-contract change in taxpayer of a contract accounted for using a long-term contract method of accounting.

* * * * *

(k) *Mid-contract change in taxpayer* — (1) *In general.* The rules in this paragraph (k) apply if prior to the completion of a long-term contract accounted for using a long-term contract method by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. For purposes of this paragraph (k) and § 1.460–6(g), an old taxpayer also includes any old taxpayer(s) (*e.g.*, predecessors) of the old taxpayer. In addition, a change in status from taxable to tax exempt or from domestic to foreign, or vice versa, will be considered a change in taxpayer. Finally, a contract will be treated as the same contract if the terms of the contract are not substantially changed in connection with the transaction, whether or not the customer agrees to release the old taxpayer from any or all of its obligations under the contract. The rules governing constructive completion transactions are provided in paragraph (k)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (k)(3) of this section. Special rules related to the treatment of certain partnership transactions are reserved under paragraphs (k)(2)(iv) and (k)(3)(v) of this section. For application of the look-back method to mid-contract changes in taxpayers for contracts accounted for using the PCM, see § 1.460–6(g).

(2) *Constructive completion transactions* — (i) *Scope*. The constructive completion rules in this paragraph (k)(2) apply to transactions (constructive completion transactions) that result in a change in the taxpayer responsible for reporting income from a contract and that are not described in paragraph (k)(3)(i) of this section. Constructive completion transactions generally include, for example, taxable sales under section 1001 and deemed asset sales under section 338.

(ii) *Old taxpayer*. The old taxpayer is treated as completing the contract on the date of the transaction. The total contract price (or, gross contract price in the case of a long-term contract accounted for under the CCM) for the old taxpayer is the sum of any amounts realized from the transaction that are allocable to the contract and any amounts the old taxpayer has received or reasonably expects to receive under the contract. Total contract price (or gross contract price) is reduced by any amount paid by the old taxpayer to the new taxpayer, and by any transaction costs, that are allocable to the contract. Thus, the old taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a

transaction subject to section 338 or 1060, the amount realized from the transaction allocable to the contract is determined by using the residual method under §§ 1.338–6 and 1.338–7.

(iii) *New taxpayer*. The new taxpayer is treated as entering into a new contract on the date of the transaction. The new taxpayer must evaluate whether the new contract should be classified as a long-term contract within the meaning of § 1.460–1(b) and account for the contract under a permissible method of accounting. For a new taxpayer who accounts for a contract using the PCM, the total contract price is any amount the new taxpayer reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Total contract price is reduced by the amount of any consideration paid by the new taxpayer as a result of the transaction, and by any transaction costs, that are allocable to the contract and is increased by the amount of any consideration received by the new taxpayer as a result of the transaction that is allocable to the contract. Similarly, the gross contract price for a contract accounted for using the CCM is all amounts the new taxpayer is entitled by law or contract to receive consistent with paragraph (d)(3) of this section, adjusted for any consideration paid (or received) by the new taxpayer as a result of the transaction, and for any transaction costs, that are allocable to the contract. Thus, the new taxpayer's allocable contract costs determined under paragraph (b)(5) of this section do not include any consideration paid, or costs incurred, as a result of the transaction that are allocable to the contract. In the case of a transaction subject to sections 338 or 1060, the amount of consideration paid that is allocable to the contract is determined by using the residual method under §§ 1.338–6 and 1.338–7.

(iv) *Special rules relating to distributions of certain contracts by a partnership*. [Reserved]

(3) *Step-in-the-shoes transactions* — (i) *Scope*. The step-in-the-shoes rules in this paragraph (k)(3) apply to the following transactions that result in a change in the taxpayer responsible for reporting income from a contract accounted for using a long-term contract method of accounting (step-in-the-shoes transactions) —

(A) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(A), (C) or (F);

(B) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(D) or (G), provided the requirements of section 354(b)(1)(A) and (B) are met;

(C) Distributions to which section 332 applies, provided the contract is transferred to an 80-percent distributee;

(D) Transfers described in section 351;

(E) Transfers to which section 361 applies if the transfer is in connection with a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met;

(F) Transfers (*e.g.*, sales) of S corporation stock;

(G) Conversion to or from an S corporation;

(H) Members joining or leaving a consolidated group;

(I) Contributions to which section 721(a) applies;

(J) Transfers of partnership interests;

(K) Distributions to which section 731 applies (other than the distribution of the contract); and

(L) Any other transaction designated in the Internal Revenue Bulletin by the Internal Revenue Service. See § 601.601(d)(2)(ii) of this chapter.

(ii) *Old taxpayer* — (A) *In general*. The new taxpayer will "step into the shoes" of the old taxpayer with respect to the contract. Thus, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer, as set forth in paragraph (k)(3)(iii) of this section. As a result, an old taxpayer using the PCM is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. Similarly, an old taxpayer using the CCM is not required to recognize any revenue and may not deduct allocable contract costs incurred with respect to the contract.

(B) *Gain realized on the transaction*. The amount of gain the old taxpayer realizes on the transfer of a contract in a step-in-the-shoes transaction must be determined after application of paragraph (k)(3)(ii)(A) of this section using the rules of paragraph (k)(2) of this section that apply to constructive completion transactions. (The amount of gain realized on a transfer of a contract is relevant, for example, in determining the amount of gain recognized with respect to the contract in a section 351 transaction in which the old taxpayer receives from the new taxpayer money or property other than stock of the transferee.)

(iii) *New taxpayer* — (A) *Method of accounting*. Beginning on the date of the transaction, the new taxpayer must account for the long-term contract by using the same method of accounting used by the old taxpayer prior to the transaction. The same method of accounting must be used for such contract regardless of whether the old taxpayer's method is the new taxpayer's principal method of accounting under § 1.381(c)(4)–1(b)(3) or whether the new taxpayer is otherwise eligible to use the old taxpayer's method. Thus, if the old taxpayer uses the PCM to account for the contract, the new taxpayer steps into the shoes of the old taxpayer with respect to its completion factor and percentage of completion methods (such as the 10-percent method), even if the new taxpayer has not elected such methods for similarly classified contracts. Similarly, if the old taxpayer uses the CCM, the new taxpayer steps into the shoes of the old taxpayer with respect to the CCM, even if the new taxpayer is not otherwise eligible to use the CCM. However, the new taxpayer is not necessarily bound by the old taxpayer's method for similarly classified contracts entered into by the new taxpayer subsequent to the transaction and must apply general tax principles, including section 381, to determine the appropriate method to account for these subsequent contracts. To the extent that general tax principles allow the taxpayer to account for similarly classified contracts using a method other than the old taxpayer's method, the taxpayer is

not required to obtain the consent of the Commissioner to begin using such other method.

(B) *Contract price*. In the case of a long-term contract that has been accounted for under PCM, the total contract price for the new taxpayer is the sum of any amounts the old taxpayer or the new taxpayer has received or reasonably expects to receive under the contract consistent with paragraph (b)(4) of this section. Similarly, the gross contract price in the case of a long-term contract accounted for under the CCM includes all amounts the old taxpayer or the new taxpayer is entitled by law or by contract to receive consistent with paragraph (d)(3) of this section.

(C) *Contract costs*. Total allocable contract costs for the new taxpayer are the allocable contract costs as defined under paragraph (b)(5) of this section incurred by either the old taxpayer prior to, or the new taxpayer after, the transaction. Thus, any payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction are not treated as allocable contract costs.

(iv) *Special rules related to certain corporate transactions*—(A) *Old taxpayer—basis adjustment*—(*1*) *In general*. Except as provided in paragraph (k)(3)(iv)(A)(*2*) of this section, in the case of a transaction described in paragraph (k)(3)(i)(D) or (E) of this section, the old taxpayer must adjust its basis in the stock of the new taxpayer by—

(*i*) Increasing such basis by the amount of gross receipts the old taxpayer has recognized under the contract; and

(*ii*) Reducing such basis by the amount of gross receipts the old taxpayer has received or reasonably expects to receive under the contract.

(*2*) *Basis adjustment in excess of stock basis*. If the old and new taxpayer do not join in the filing of a consolidated Federal income tax return, the old taxpayer may not adjust its basis in the stock of the new taxpayer under paragraph (k)(3)(iv)(A)(*1*) of this section below zero and the old taxpayer must recognize ordinary income to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero. If the old and new taxpayer join in the filing of a consolidated Federal income tax return, the old taxpayer must create an (or increase an existing) excess loss account to the extent the basis in the stock of the new taxpayer otherwise would be adjusted below zero under paragraph (k)(3)(iv)(A)(*1*) of this section. See §§ 1.1502–19 and 1.1502–32(a)(3)(ii).

(*3*) *Subsequent dispositions of certain contracts*. If the old taxpayer disposes of a contract in a transaction described in paragraph (k)(3)(i)(D) or (E) of this section that the old taxpayer acquired in a transaction described in paragraph (k)(3)(i)(D) or (E) of this section, the basis adjustment rule of this paragraph (k)(3)(iv)(A) is applied by treating the old taxpayer as having recognized the amount of gross receipts recognized by the previous old taxpayer under the contract and any amount recognized by the previous old taxpayer with respect to the contract in connection with the transaction in which the old taxpayer acquired the contract. In addition, the old taxpayer is treated as having received or as reasonably expecting to receive under the contract any amount the previous old taxpayer received or reasonably expects to receive under the contract. Similar principles will apply in the case of multiple successive transfers described in paragraph (k)(3)(i)(D) or (E) of this section involving the contract.

(B) *New Taxpayer*—(1) *Contract price adjustment*. Generally, payments between the old taxpayer and the new taxpayer with respect to the contract in connection with the transaction do not affect the contract price. Notwithstanding the preceding sentence and paragraph (k)(3)(iii)(B) of this section, however, in the case of transactions described in paragraph (k)(3)(i)(B), (D) or (E) of this section, the total contract price (or gross contract price) must be reduced to the extent of any amount recognized by the old taxpayer with respect to the contract in connection with the transaction (*e.g.*, any amount recognized under section 351(b) or 357 that is attributable to the contract and any income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)).

(2) *Basis in Contract*. The new taxpayer's basis in a contract (including the uncompleted property, if applicable) acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) of this section will be computed under section 362 or section 334, as applicable. Upon a new taxpayer's completion (actual or constructive) of a CCM or a PCM contract acquired in a transaction described in paragraphs (k)(3)(i)(A) through (E) of this section, the new taxpayer's basis in the contract (including the uncompleted property, if applicable) is reduced to zero. The new taxpayer is not entitled to a deduction or loss in connection with any basis reduction pursuant to this paragraph (k)(3)(iv)(B)(*2*).

(v) *Special rules related to certain partnership transactions*. [Reserved]

(4) *Anti-abuse rule*. Notwithstanding this paragraph (k), in the case of a transaction entered into with a principal purpose of shifting the tax consequences associated with a long-term contract in a manner that substantially reduces the aggregate U.S. Federal income tax liability of the parties with respect to that contract, the Commissioner may allocate to the old (or new) taxpayer the income from that contract properly allocable to the old (or new) taxpayer. For example, the Commissioner may reallocate income from a long-term contract in a transaction in which a contract accounted for using the CCM, or using the PCM where the old taxpayer has received advance payments in excess of its contribution to the contract, is transferred to a tax indifferent party (*e.g.*, a foreign person not subject to U.S. Federal income tax).

(5) *Examples*. The following examples illustrate the rules of this paragraph (k). For purposes of these examples, it is assumed that the contract is a long-term construction contract accounted for using the PCM prior to the transaction unless stated otherwise and the contract is not transferred with a principal purpose of shifting the tax consequences associated with a long-term contract in a manner that substantially reduces the aggregate U.S. Federal income tax liability of the parties with respect to that contract. The examples are as follows:

Example 1. Constructive completion –PCM

(i) *Facts*. In Year 1, X enters into a contract. The total contract price is $1,000,000 and the estimated total allocable contract costs are $800,000. In Year 1, X incurs costs of $200,000. In Year 2, X incurs additional costs of $400,000 before selling the contract as part of a taxable sale of its business in Year 2 to Y, an unrelated party. At the time of sale, X has received $650,000 in progress payments under the contract. The consideration allocable to the contract

under section 1060 is $150,000. Pursuant to the sale, the new taxpayer Y immediately assumes X's contract obligations and rights. Y is required to account for the contract using the PCM. In Year 2, Y incurs additional allocable contract costs of $50,000. Y correctly estimates at the end of Year 2 that it will have to incur an additional $75,000 of allocable contract costs in Year 3 to complete the contract.

(ii) *Old taxpayer*. For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 x $1,000,000)) and costs of $200,000, for a profit of $50,000. X is treated as completing the contract in Year 2 because it sold the contract. For purposes of applying the PCM in Year 2, the total contract price is $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and the total allocable contract costs are $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)). Thus, in Year 2, X reports receipts of $550,000 (total contract price minus receipts already reported ($800,000 - $250,000)) and costs incurred in year 2 of $400,000, for a profit of $150,000.

(iii) *New taxpayer*. Y is treated as entering into a new contract in Year 2. The total contract price is $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 - $650,000 - $150,000)). The estimated total allocable contract costs at the end of Year 2 are $125,000 (the allocable contract costs that Y reasonably expects to incur to complete the contract ($50,000 + $75,000)). In Year 2, Y reports receipts of $80,000 (the completion factor multiplied by the total contract price [($50,000/$125,000) x $200,000] and costs of $50,000 (the costs incurred after the purchase), for a profit of $30,000. For Year 3, Y reports receipts of $120,000 (total contract price minus receipts already reported ($200,000 - $80,000)) and costs of $75,000, for a profit of $45,000.

Example 2. Constructive completion—CCM—(i) *Facts*. The facts are the same as in *Example 1*, except that X and Y properly account for the contract under the CCM.

(ii) *Old taxpayer*. X does not report any income or costs from the contract in Year 1. In Year 2, the contract is deemed complete for X, and X reports its gross contract price of $800,000 (the sum of the amounts received under the contract and the amount realized in the sale ($650,000 + $150,000)) and its total allocable contract costs of $600,000 (the sum of the costs incurred in Year 1 and Year 2 ($200,000 + $400,000)) in that year, for a profit of $200,000.

(iii) *New taxpayer*. Y is treated as entering into a new contract in Year 2. Under the CCM, Y reports no gross receipts or costs in Year 2. Y reports its gross contract price of $200,000 (the amount remaining to be paid under the terms of the contract less the consideration paid allocable to the contract ($1,000,000 - $650,000 - $150,000)) and its total allocable contract costs of $125,000 (the allocable contract costs that Y incurred to complete the contract ($50,000 + $75,000)) in Year 3, the completion year, for a profit of $75,000.

Example 3. Step-in-the-shoes — PCM — (i) *Facts*. The facts are the same as in *Example 1*, except that X transfers the contract (including the uncompleted property) to Y in exchange for stock of Y in a transaction that qualifies as a statutory merger described in section 368(a)(1)(A) and does not result in gain or loss to X under section 361(a).

(ii) *Old taxpayer*. For Year 1, X reports receipts of $250,000 (the completion factor multiplied by total contract price ($200,000/$800,000 x $1,000,000)) and costs of $200,000, for a profit of $50,000. Because the mid-contract change in taxpayer results from a transaction described in paragraph (k)(3)(i) of this section, X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (the completion factor multiplied by the total contract price and minus the Year 1 gross receipts [($600,000/$800,000 x $1,000,000) - $250,000]) and costs of $400,000, for a profit of $100,000.

(iii) *New taxpayer*. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same methods of accounting used by X prior to the transaction. Total contract price is the sum of any amounts that X and Y have received or reasonably expect to receive under the contract, and total allocable contract costs are the allocable contract costs of X and Y. Thus, the estimated total allocable contract costs at the end of Year 2 are $725,000 (the cumulative allocable contract costs of X and the estimated total allocable contract costs of Y ($200,000 + $400,000 + $50,000 + $75,000)). In Year 2, Y reports receipts of $146,552 (the completion factor multiplied by the total contract price minus receipts reported by the old taxpayer ([($650,000/$725,000) x $1,000,000] - $750,000) and costs of $50,000, for a profit of $96,552. For Year 3, Y reports receipts of $103,448 (the total contract price minus prior year receipts ($1,000,000 - $896,552)) and costs of $75,000, for a profit of $28,448.

Example 4. Step-in-the-shoes — CCM — (i) *Facts*. The facts are the same as in *Example 3*, except that X properly accounts for the contract under the CCM.

(ii) *Old taxpayer*. X reports no income or costs from the contract in Years 1, 2 or 3.

(iii) *New taxpayer*. Because the mid-contract change in taxpayer results from a step-in-the-shoes transaction, Y must account for the contract using the same method of accounting used by X prior to the transaction. Thus, in Year 3, the completion year, Y reports receipts of $1,000,000 and total contract costs of $725,000, for a profit of $275,000.

Example 5. Step in the shoes — PCM — basis adjustment. The facts are the same as in *Example 3*, except that X transfers the contract (including the uncompleted property) with a basis of $0 and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. Thus, under section 358(a), X's basis in the Z stock is $125,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in the Z stock by the amount of gross receipts X recognized under the contract, $750,000 ($250,000 receipts in Year 1 + $500,000 receipts in Year 2), and reduce its basis by the amount of gross receipts X received under the còntract, the $650,000 in progress payments. Accordingly, X's basis in the Z stock is $225,000. All other results are the same.

Example 6. Step in the shoes—CCM—basis adjustment—(i) *Facts*. The facts are the same as in *Example 4*, except that X receives progress payments of $800,000 (rather than $650,000) and transfers the contract (including the uncompleted property) with a basis of $600,000 and $125,000 of cash to a new corporation, Z, in exchange for all of the stock of Z in a section 351 transaction. X and Z do not join in filing a consolidated Federal income tax return.

(ii) *Old taxpayer*. X reports no income or costs under the contract in Years 1, 2, or 3. Under section 358(a), X's basis in Z is $725,000. Pursuant to paragraph (k)(3)(iv)(A)(*1*), X must reduce its basis in the stock of Z by $800,000, the progress payments received by X. However, X may not reduce its basis in the Z stock below zero pursuant paragraph (k)(3)(iv)(A)(*2*) of this section. Accordingly, X's basis in the Z stock is reduced by $725,000 to zero and X must recognize ordinary income of $75,000.

(iii) *New taxpayer*. Upon completion of the contract in Year 3, Z reports gross receipts of $925,000 ($1,000,000 original contract price - $75,000 income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)) and total contract costs of $725,000, for a profit of $200,000.

Example 7. Step in the shoes—PCM—gain recognized in transaction—(i) *Facts*. The facts are the same as in *Example 3*, except that X transfers the contract (including the uncompleted property) with a basis of $0 and an unrelated capital asset with a value of $100,000 and a basis of $0 to a new corporation, Z, in exchange for stock of Z with a value of $200,000 and $50,000 of cash in a section 351 transaction.

(ii) *Old taxpayer*. For year 1, X reports receipts of $250,000 ($200,000/$800,000 x $1,000,000) and costs of $200,000, for a profit of $50,000. X is not treated as completing the contract in Year 2. In Year 2, X reports receipts of $500,000 (($600,000/$800,000 x $1,000,000 = $750,000 cumulative gross receipts) - $250,000 prior year cumulative gross receipts) and costs of $400,000, for a profit of $100,000. Under paragraph (k)(3)(ii)(B) of this section, X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is $50,000 (total contract price of $800,000 ($150,000 value allocable to the contract + $650,000 progress payments) - $750,000 previously recognized cumulative gross receipts — $0 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is $100,000. The amount of gain X must recognize due to the receipt of $50,000 cash in the exchange is $50,000, of which $30,000 is allocated to the contract ($150,000 value of contract/$250,000 total value of property transferred to Z x $50,000) and is treated as ordinary income, and $20,000 is allocated to the unrelated capital asset ($100,000 value of capital asset/$250,000 total value of property transferred to Z x $50,000). Under section 358(a), X's basis in the Z stock is $0. However, pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must increase its basis in the Z stock by $750,000, the amount of gross receipts recognized under the contract, and must reduce its basis in the Z stock by $650,000, the amount of gross receipts X received under the contract. Therefore, X's basis in the Z stock is $100,000.

(iii) *New taxpayer*. Z must account for the contract using the same PCM method used by X prior to the transaction. Pursuant to paragraph

(k)(3)(iv)(B)(*1*) of this section, the total contract price is $970,000 ($1,000,000 amount X and Z have received or reasonably expect to receive under the contract - $30,000 income recognized by X with respect to the contract as a result of the receipt of $50,000 cash in the transaction). In Year 2, Z reports gross receipts of $119,655 ($650,000/$725,000 x $970,000 = $869,655 current year cumulative gross receipts - $750,000 cumulative gross receipts reported by the old taxpayer) and costs of $50,000, for a profit of $69,655. In Year 3, Z reports gross receipts of $100,345 ($970,000-$869,655) and costs of $75,000, for a profit of $25,345.

Example 8. Step in the shoes—CCM—gain recognized in transaction—(i) *Facts*. The facts are the same as in *Example 4*, except that X transfers the contract (including the uncompleted property) with a basis of $600,000 and an unrelated capital asset with a value of $125,000 and a basis of $0 to a new corporation, Z, in exchange for all the stock of Z with a value of $175,000 and $100,000 of cash in a section 351 transaction. X and Z do not join in filing a consolidated Federal income tax return.

(ii) *Old taxpayer*. X reports no income or costs under the contract in Years 1, 2, or 3. Under paragraph (k)(3)(ii)(B), X determines that the gain realized on the transfer of the contract to Z under the constructive completion rules of paragraph (k)(2)(ii) of this section is $200,000 ($800,000 total contract price ($150,000 value allocable to the contract + $650,000 progress payments) - $600,000 costs incurred but not recognized). The gain realized on the transfer of the unrelated capital asset to Z is $125,000. The amount of gain X must recognize due to the receipt of $100,000 of cash in the exchange is $100,000, of which $54,545 is allocated to the contract ($150,000 value of the contract/$275,000 total value of property transferred to Z x $100,000) and is treated as ordinary income, and $45,455 is allocated to the unrelated capital asset ($125,000 value of capital asset/$275,000 total value of property transferred to Z x $100,000). Under section 358(a), X's basis in the Z stock is $600,000 ($600,000 basis in the contract and unrelated capital asset transferred - $100,000 cash received + $100,000 gain recognized). Pursuant to paragraph (k)(3)(iv)(A)(*1*) of this section, X must reduce its basis in the stock of Z by $650,000, the progress payments received under the contract. However, X may not reduce its basis in the Z stock below zero pursuant to paragraph (k)(3)(iv)(A)(*2*) of this section. Accordingly, X's basis in the Z stock is reduced by $600,000 to zero and X must recognize income of $50,000.

(iii) *New taxpayer*. Z must account for the contract using the same CCM used by X prior to the transaction. Pursuant to paragraph (k)(3)(iv)(B)(1) of this section, the total contract price is $895,455 ($1,000,000 original contract price - $54,545 income recognized by old taxpayer with respect to the contract as a result of the receipt of cash in the transaction - $50,000 income recognized by the old taxpayer pursuant to the basis adjustment rule of paragraph (k)(3)(iv)(A)). Accordingly, upon completion of the contract in Year 3, Z reports gross receipts of $895,455 and total contract costs of $725,000, for a profit of $170,455.

(6) *Effective date*. This paragraph (k) is applicable for transactions on or after May 15, 2002. Application of the rules of this paragraph (k) to a transaction that occurs on or after May 15, 2002, is not a change in method of accounting.

Par. 8. In § 1.460–6, paragraph (g) is revised to read as follows:

§ 1.460–6 Look-back method.

* * * * *

(g) *Mid-contract change in taxpayer* — (1) *In general*. The rules in this paragraph (g) apply if, as described in § 1.460–4(k), prior to the completion of a long-term contract accounted for using the PCM or the PCCM by a taxpayer (old taxpayer), there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. The rules governing constructive completion transactions are provided in paragraph (g)(2) of this section, while the rules governing step-in-the-shoes transactions are provided in paragraph (g)(3) of this section. For purposes of this paragraph, pre-transaction years are all taxable years of the old taxpayer in which the old taxpayer accounted for (or should have accounted for) gross receipts from the contract, and post-transaction years are all taxable years of the new taxpayer in which the new taxpayer accounted for (or should have accounted for) gross receipts from the contract.

(2) *Constructive completion transactions*. In the case of a transaction described in § 1.460–4(k)(2)(i) (constructive completion transaction), the look-back method is applied by the old taxpayer with respect to pre-transaction years upon the date of the transaction and, if the new taxpayer uses the PCM or the PCCM to account for the contract, by the new taxpayer with respect to post-transaction years upon completion of the contract. The contract price and allocable contract costs to be taken into account by the old taxpayer or the new taxpayer in applying the look-back method are described in § 1.460–4(k)(2).

(3) *Step-in-the-shoes transactions* — (i) *General rules*. In the case of a transaction described in § 1.460–4(k)(3)(i) (step-in-the-shoes transaction), the look-back method is not applied at the time of the transaction, but is instead applied for the first time when the contract is completed by the new taxpayer. Upon completion of the contract, the look-back method is applied by the new taxpayer with respect to both pre-transaction years and post-transaction years, taking into account all amounts reasonably expected to be received by either the old or new taxpayer and all allocable contract costs incurred during both periods as described in § 1.460–4(k)(3). The new taxpayer is liable for filing the Form 8697 and for interest computed on hypothetical underpayments of tax, and is entitled to receive interest with respect to hypothetical overpayments of tax, for both pre- and post-transaction years. The old taxpayer will be secondarily liable for any interest required to be paid with respect to pre-transaction years reduced by any interest on pre-transaction overpayments.

(ii) *Application of look-back method to pre-transaction period* — (A) *Contract price*. The actual contract price for pre-transaction taxable years must be determined by the new taxpayer without regard to any contract price adjustment described in paragraph (k)(3)(iv)(B)(1) of this section.

(B) *Method*. The new taxpayer may apply the look-back method to each pre-transaction taxable year that is a redetermination year using the simplified marginal impact method described in paragraph (d) of this section (regardless of whether or not the old taxpayer would have actually used that method and without regard to the tax liability ceiling). But see paragraph (d)(4) of this section, which requires use of the simplified marginal impact method by certain pass-through entities.

(C) *Interest accrual period*. With respect to any hypothetical underpayment or overpayment of tax for a pre-transaction taxable year, interest accrues from the due date of the old taxpayer's tax return (not including extensions) for the taxable year of the underpayment or overpayment until the due date of the new taxpayer's return (not including extensions) for the completion year or the year of a post-completion adjustment, whichever is applicable.

(D) *Information old taxpayer must provide*. In order to help the new taxpayer to apply the look-back method with respect to pre-transaction taxable years, any old taxpayer that accounted for income from a long-term contract under the PCM or PCCM for either regular or

alternative minimum tax purposes is required to provide the information described in this paragraph to the new taxpayer by the due date (not including extensions) of the old taxpayer's income tax return for the first taxable year ending on or after a step-in-the-shoes transaction described in § 1.460–4(k)(3)(i). The required information is as follows —

(*1*) The portion of the contract reported by the old taxpayer under PCM for regular and alternative minimum tax purposes (*i.e.*, whether the old taxpayer used PCM, the 40/60 PCCM method, or the 70/30 PCCM method);

(*2*) Any submethods used in the application of PCM (*e.g.*, the simplified cost-to-cost method or the 10-percent method);

(*3*) The amount of total contract price reported by year;

(*4*) The numerator and the denominator of the completion factor by year;

(*5*) The due date (not including extensions) of the old taxpayer's income tax returns for each taxable year in which income was required to be reported;

(*6*) Whether the old taxpayer was a corporate or a noncorporate taxpayer by year; and

(*7*) Any other information required by the Commissioner by administrative pronouncement.

(iii) *Application of look-back method to post-transaction years.* With respect to post-transaction taxable years, the new taxpayer must use the same look-back method it uses for other contracts (*i.e.*, the simplified marginal impact method or the actual method) to determine the amount of any hypothetical overpayment or underpayment of tax and the time period for computing interest on these amounts.

(iv) *S corporation elections.* Following the conversion of a C corporation into an S corporation, the look-back method is applied at the entity level with respect to contracts entered into prior to the conversion, notwithstanding section 460(b)(4)(B)(i).

(4) *Effective date.* This paragraph (g) is applicable for transactions on or after May 15, 2002.

§ 1.1362–2 [Amended]

Par. 9. In § 1.1362–2, paragraph (c)(6) *Example 2*, first sentence is amended by removing the language "§ 1.451–3(b)" and adding "§ 1.460–1(b)(1)" in its place, and removing the language "§ 1.451–3(c)(1)" and adding "§ 1.460–4(b)" in its place.

§ 1.1374–4 [Amended]

Par. 10. In § 1.1374–4, paragraph (g), first sentence is amended by removing the language "§ 1.451–3(d)" and adding "§ 1.460–4(d)" in its place, and removing the language "§ 1.451–3(c)" and adding "§ 1.460–4(b)" in its place.

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority section for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 12. In § 602.101, paragraph (b) is amended by revising the following entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.460–6	1545–1031 1545–1572 1545–1732
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved May 2, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 14, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 15, 2002, 67 F.R. 34603)

Section 1361.—S Corporation Defined

26 CFR 1.1361–1: S corporation defined.

T.D. 8994

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Electing Small Business Trust

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the qualification and treatment of electing small business trusts (ESBTs). The final regulations interpret the rules added to the Internal Revenue Code (Code) by section 1302 of the Small Business Job Protection Act of 1996, section 1601 of the Taxpayer Relief

Act of 1997, and section 316 of the Community Renewal Tax Relief Act of 2000. In addition, the final regulations provide that an ESBT, or a trust described in section 401(a) of the Code or section 501(c)(3) of the Code and exempt from taxation under section 501(a) of the Code, is not treated as a deferral entity for purposes of § 1.444–2T. The final regulations affect S corporations and certain trusts that own S corporation stock.

DATES: *Effective Date*: These regulations are effective May 14, 2002.

Dates of Applicability: The regulations regarding ESBTs under § 1.641(c)–1(d) through (k), (l) *Examples 2 – 5*, § 1.1361–1(h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), (j)(12), and (m), § 1.1362–6(b)(2)(iv), § 1.1377–1(a)(2)(iii) and (c) *Example 3* apply for taxable years beginning on and after May 14, 2002. The regulations regarding taxation of ESBTs under § 1.641(c)–1(a), (b), (c), and (l) *Example 1* are applicable for taxable years of ESBTs that end on and after December 29, 2000. The regulations under § 1.444–4 are applicable to taxable years beginning on or after December 29, 2000.

FOR FURTHER INFORMATION CONTACT: Concerning the final regulations, Bradford Poston or James A. Quinn, (202) 622–3060; specifically concerning § 1.444–4, Michael F. Schmit, (202) 622–4960 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information in these final regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) and assigned control number 1545–1591.

The collections of information in these final regulations are in § 1.1361–1(j)(12), § 1.1361–1(m), and § 1.444–4(c). The information required by § 1.1361–1(j)(12) and § 1.1361–1(m) is needed to allow trusts to elect to be ESBTs and to allow for the conversion of a qualified subchapter S trust (QSST) to an ESBT and the conversion of an ESBT to a QSST. The likely respondents are trusts.

The information required by § 1.444–4 (c) is needed to allow certain S corporations to reinstate their previous taxable year that was terminated under § 1.444–2T. The likely respondents are businesses and other for-profit institutions.

Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn.: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503 with copies to the **Internal Revenue Service**, Attn.: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by July 15, 2002. Comments are specifically requested concerning:

Whether the collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the collections of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs of operation, maintenance, and purchase of service to provide information.

The burden contained in § 1.444–4 is reflected in the burden of Form 8716.

Estimated total annual reporting burden: 7,500 hours.

Estimated annual burden per respondent: 1 hour.

Estimated number of respondents: 7,500.

Estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On December 29, 2000, proposed regulations (REG–251701–96, 2001–1 C.B. 396) were published in the **Federal Register** (65 FR 82963) containing proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to S corporations and electing small business trusts (ESBTs). Section 1302 of the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755) (August 20, 1996) (the 1996 Act), amended sections 641 and 1361 of the Code to permit an ESBT to be an S corporation shareholder. Further amendments were made to section 1361(e) by the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 1601(c)(1)) (August 5, 1997), and the Community Renewal Tax Relief Act of 2000, Public Law 106–554 (114 Stat. 2763) (December 21, 2000). Prior section 641(d) was redesignated as section 641(c) by the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206 (112 Stat. 6007(f)(2)) (July 22, 1998).

On December 29, 2000, proposed and temporary regulations were also published in the **Federal Register** (REG–251701–96, 2001–1 C.B. 396 [65 FR 82963]) and (T.D. 8915, 2001–1 C.B. 359 [65 FR 82926]) containing amendments to the Income Tax Regulations (26 CFR Part 1) relating to the election of a taxable year other than the required taxable year.

A public hearing was held on the proposed and temporary regulations on April 25, 2001. Written comments were received on the proposed and temporary regulations. The proposed regulations, with certain changes in response to the comments, are adopted as final regulations, and the temporary regulations are removed.

Summary of Comments and Explanation of Revisions

Beneficiaries and Potential Current Beneficiaries

For a trust to qualify as an electing small business trust (ESBT) and as a

shareholder in a subchapter S corporation, only certain types of persons are permitted to be beneficiaries of the trust. Once a trust makes the ESBT election, each potential current beneficiary (PCB) of the trust is treated as a shareholder of the S corporation. Thus, the identity of the beneficiaries affects whether a trust can be an ESBT, while the identity and number of PCBs affect whether the corporation can be a S corporation. It is possible under certain circumstances for a person to be a PCB, as that term is defined in section 1361(e)(2) and the proposed regulations, without being a beneficiary, as that term is defined in the proposed regulations. For example, a person who may receive a distribution from an ESBT under a currently exercisable power of appointment is a PCB but is not treated as a beneficiary until the power is actually exercised.

Some commentators expressed concerns about the possible adverse effects of the definition of PCBs, especially in situations involving potential recipients of a currently exercisable power of appointment. Some commentators suggested that a person should have to meet the definition of a beneficiary before the person could be considered a PCB. Commentators also suggested that a person who may receive a distribution under a currently exercisable power of appointment should not be treated as a PCB until exercise of the power. Several commentators suggested that a temporary waiver or release of a broad power of appointment should be sufficient to limit the number of PCBs during a period of time.

The final regulations do not change the basic definition of PCBs. While there is no statutory definition of beneficiary in section 1361(e), there is a statutory definition of PCB. Under section 1361(e)(2), a PCB is, "with respect to any period, any person who at any time during such period is entitled to, or, at the discretion of any person, may receive, a distribution from the principal or income of the trust." The IRS and the Treasury Department believe that it would be inconsistent with this statutory definition not to treat a person as a PCB until an actual distribution is made to that person pursuant to the exercise of a power of appointment. The final regulations provide that an attempt to temporarily waive, release, or limit a power of appointment would not be effective to limit the PCBs because of uncertainty as to the effectiveness of a temporary waiver, release, or limitation on the power of appointment under state law and the potential to manipulate a temporary waiver, release, or limitation on a power of appointment to avoid the S corporation shareholder limitation rules. However, a permanent release of a power of appointment that is effective under local law may reduce the number of PCBs of an ESBT.

Another commentator suggested that the separate share provisions of section 663(c) should apply so that beneficiaries or PCBs of the share holding the assets other than the S corporation stock would not be counted as beneficiaries or PCBs of the S portion. There is no authority to ignore beneficiaries and PCBs of a portion of a trust holding assets other than S corporation stock. The statutory definitions of an ESBT and of a PCB look to all the persons who are beneficiaries or PCBs of the trust, not just the S portion. In addition, the separate share provisions of section 663(c) are not applicable because they generally apply only for purposes of allocating distributable net income under sections 661 and 662.

Two commentators requested guidance on what period of time is considered in determining who are PCBs in light of the statutory definition. They suggested that *period* means any moment in time. Thus, if an event occurs during a taxable year that changes who the PCBs are, the PCBs before and after the event would not be counted cumulatively for purposes of the 75-shareholder limit. The shareholder limitation in section 1361(b)(1)(A) means that an S corporation may not have more than 75 shareholders at any particular time during the taxable year. See Rev. Rul. 78–390, 1978–2 C.B. 220. The final regulations clarify that a person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. The final regulations also provide that a person who, after the exercise of a power of appointment, receives only a future interest in the trust is not a PCB.

One commentator was concerned about the statement in the proposed regulations that if a person holds a general lifetime power of appointment, the corporation will exceed the 75-shareholder limit and thus the corporation's S election will terminate. The commentator pointed out that a beneficiary's power to withdraw assets from a trust is considered a general power of appointment but the beneficiary is the only one who can receive those assets. The final regulations clarify that the potential recipients of current distributions pursuant to an exercise of the power are considered, not whether the power is a general or special power of appointment.

The proposed regulations provide that a person with a future beneficial interest is not a beneficiary of an ESBT if that interest is so remote as to be negligible. This provision permitted trusts to qualify as ESBTs even though there was a remote possibility that all the named beneficiaries would die and the trust assets would escheat to the state, an impermissible beneficiary of an ESBT. The Community Renewal Tax Relief Act of 2000 eliminated this potential problem by changing the statutory definition of permissible beneficiaries to include an organization described in section 170(c)(1) that holds a contingent interest in the trust and is not a PCB. The final regulations, therefore, remove the provision regarding remote beneficiaries and the accompanying example.

Interests in Trust Acquired by Purchase

Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines *purchase* as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify that the prohibition on purchases applies to purchases of a beneficiary's interest in the trust, not to

purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

Grantor Trusts

Most commentators praised the position in the proposed regulations that a trust, all or a portion of which is treated as owned by an individual (deemed owner) under subpart E, part I, subchapter J, chapter 1 of the Code (grantor trust), may elect to be an ESBT. One commentator, however, suggested that grantor trusts should not be permitted to make ESBT elections. The final regulations continue to provide that a grantor trust may elect to be an ESBT.

The proposed regulations provide that if a grantor trust makes an ESBT election, the trust consists of a grantor portion, an S portion, and a non-S portion. The items of income, deduction, and credit attributable to the grantor portion are taxed to the deemed owner of that portion. The S portion is taxed under the special rules of section 641(c), while the non-S portion is subject to the normal trust taxation rules of subparts A through D of subchapter J.

Commentators made several suggestions regarding the taxation of a grantor trust that elects to be an ESBT. Some suggested that the taxation rules of section 641(c) should override the grantor trust rules of section 671, and thus all tax items attributable to the trust's shares in the S corporation should be taxed to the trust, not the deemed owner. Some suggested the grantor trust rules should not apply to any tax items of a trust that makes an ESBT election. According to these commentators, this approach would eliminate administrative complexity in determining what portion of the trust is treated as owned by the deemed owner. Others suggested that the trustee should be permitted to elect to have all items attributable to the S corporation taxed to the trust, not to the deemed owner. Others suggested that none of the S items should be taxed to the deemed owner but that ESBTs should be subject to additional reporting requirements to ensure the collection of the proper tax. Another suggested that the deemed owner should be taxed on the items from an ESBT only if the deemed owner is treated as owning the entire trust, not just a portion of the trust. Other commentators agreed with the taxation regime set forth in the proposed regulations.

The IRS and the Treasury Department believe that the qualification and taxation of ESBTs are two separate issues and that the proposed regulations take the correct position regarding the taxation of grantor trusts that make ESBT elections. Section 1361(e)(1) expands the permissible shareholders of an S corporation to include trusts that meet the definition of an ESBT. Grantor trusts are not excluded from the definition of an ESBT and, therefore, are permitted to make ESBT elections. Making an ESBT election, however, does not alter the long established treatment of tax items attributable to the portion of a trust treated as owned by the grantor or another. Section 671 requires that items of income, deduction, and credit attributable to the portion of the trust treated as owned by a grantor or another must be taken into account by that deemed owner. Only remaining items of the trust are subject to the provisions of subparts A through D of subchapter J. The special taxation rules for ESBTs are contained in subpart A and, therefore, only apply to any portion of the trust that is not treated as owned by the grantor or another under subpart E.

As pointed out by one of the commentators, the issue of determining what portion, if any, of a trust is treated as owned by the grantor or another has existed for years in a much broader context than in the application of the ESBT rules. The special taxation rules of section 641(c) would apply only to S items, while normal trust taxation rules clearly apply to non-S items. As a result, taxing all the S items to the trust would not eliminate the need to determine what portion of the trust is a grantor trust and the resulting administrative difficulties with respect to the non-S tax items of the trust.

Some commentators requested clarification of the effect of an ESBT election by a grantor trust. One commentator suggested that if a wholly-owned grantor trust makes an ESBT election, only the deemed owner should be treated as the shareholder of the S corporation. Another commentator made a similar suggestion where the grantor has retained the power to amend or revoke the trust or to make gifts from the trust. The IRS and the Treasury Department believe that the definitional and qualification requirements of section 1361(e) apply to any trust that makes an ESBT election irrespective of whether it is a grantor trust. Therefore, the final regulations continue to provide that the deemed owner is treated as a PCB along with others who meet the definition of a PCB.

Charitable Contributions

The proposed regulations provide that if an otherwise allowable deduction of the S portion is attributable to a charitable contribution paid by the S corporation, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument and will be deductible if the other requirements of section 642(c)(1) are met. Several commentators requested clarification concerning the other requirements of section 642(c)(1), the application of the limitations under section 681, and the election to treat charitable payments made after the close of a taxable year as made during the taxable year. One commentator suggested that the S portion should be entitled to a deduction for its share of any charitable contribution made by the S corporation because it is a separately stated item under section 1366 that the S portion takes into account under section 641(c)(2)(C)(i).

Section 641(c)(2)(C) specifies the items of income, loss, deduction, or credit that the S portion is required to take into account in determining its tax. These items include items required to be taken into account under section 1366, that is, the trust's *pro rata* share of the S corporation's items passed through to it as a shareholder. Both section 641(c)(2)(C) and section 1366(a) reference items that must be taken into account but do not themselves provide the authority to include in income, deduct from income, or claim a credit with respect to those items. That authority comes from other Code sections. A charitable contribution made by an S corporation is required to be a separately stated item under section 1366 because whether the item is deductible depends on the identity of the shareholder and the provisions of the Code

applicable to charitable contributions made by that type of shareholder. Thus, for an individual shareholder, the contribution is deductible only in accordance with the provisions of section 170, while for a trust or estate, the contribution is deductible only in accordance with the provisions of section 642(c).

The final regulations continue to provide that the S portion's share of a charitable contribution made by the S corporation is deductible only if it meets the requirements of section 642(c)(1). The final regulations clarify how those requirements apply to such a contribution. If a contribution is paid from the S corporation's gross income, the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument. The limitations of section 681, regarding unrelated business income, apply to determine whether the contribution is deductible by the S portion. The final regulations also clarify that the charitable contribution is deductible by the S portion, if at all, only in the year that it is an item required to be taken into account by the trust under section 1366. The trustee may not make the election to treat a contribution made by the S corporation after the close of the taxable year as made during the taxable year. This election is available only for charitable payments actually made by the trust, not for the trust's share of contributions made by another entity.

One commentator suggested that if the trust contributes S corporation stock to a charitable organization, the S portion should be entitled to a charitable deduction with respect to the contribution. Deductions available to the S portion are limited by section 641(c)(2)(C) to S corporation items required to be taken into account under section 1366 and the S portion's share of state and local income taxes and administrative expenses. Charitable contributions by the trust are not items included in the list of items that may be taken into account by the S portion under section 641(c)(2)(C). Therefore, the final regulations do not change the rule that no deduction is available to either the S portion or the non-S portion with respect to a contribution of S corporation stock to charity.

Interest Paid on Loans to Acquire S Corporation Stock

The proposed regulations provide that interest expense incurred by the trust to purchase S corporation stock is allocated to the S portion but is not an administrative expense. Therefore, the interest is not an allowable deduction of the S portion under section 641(c)(2)(C)(iii). Several commentators suggested that the interest should be deductible. Some thought the interest should be allocated to the non-S portion and deducted under the investment interest limitations of section 163(d). Others thought the interest should be allocated to the S portion but should be considered a deductible administrative expense. One commentator suggested that if the shareholders are required to buy the stock of a departing shareholder pursuant to the terms of a stock purchase agreement, any interest expense incurred as a result of financing the stock purchase with a loan should be deductible when paid by an ESBT. Another commentator suggested that if interest paid on a loan to acquire S corporation stock is not deductible, it should be added to the basis of the acquired stock.

Because the purchase of S corporation stock increases the S portion, rather than the non-S portion, of the trust, interest expenses incurred in the purchase should be allocated to the S portion. These interest expenses would be deductible by the S portion only if they are "administrative expenses" under section 641(c)(2)(C)(iii). The IRS and the Treasury Department believe that, for purposes of section 641(c)(2)(C)(iii), "administrative expenses" include the traditional expenses necessary for the management and preservation of trust assets, but do not include expenses incurred to acquire additional assets. The final regulations, therefore, continue to provide that, in all cases, interest incurred to purchase S corporation stock is a nondeductible expense allocable to the S portion. Because there is no authority to permit nondeductible interest expenses to increase the basis of assets, the final regulations do not adopt this suggestion.

Tax Credit Carryovers

Section 641(c)(4) and the proposed regulations provide that if a trust is no longer an ESBT, any loss carryover or excess deductions of the S portion that are referred to in section 642(h) are taken into account by the entire trust or by the beneficiaries if the entire trust terminates. One commentator suggested that any tax credit carryovers of the S portion should receive similar treatment. Section 641(c)(4) permits the entire trust to take into account only those items specified in section 642(h), which does not include tax credit carryovers. The S portion's tax credit carryovers and any other items not listed in section 642(h) are forfeited once the trust is no longer an ESBT, just as they are upon the termination of a trust or estate. The final regulations, therefore, do not adopt the commentator's suggestion.

Distributions From the ESBT

One commentator suggested that the tax treatment of distributions to beneficiaries in the proposed regulations is inconsistent with section 641(c)(1)(A), which provides that the portion of an ESBT consisting of the S corporation stock is treated as a separate trust. The proposed regulations provide that distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are, to the extent of the distributable net income of the non-S portion, deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are includible in the gross income of the beneficiaries under section 652 or 662. The commentator recommended that, because the S portion and the non-S portion are treated as separate trusts, the source of the distribution should determine its tax treatment.

The final regulations do not adopt the commentator's suggestion because section 641(c)(3) provides that section 641(c) does not affect the taxation of any distribution from the trust except for the exclusion of the S portion items from the distributable net income of the entire trust. Thus, the rules otherwise applicable to trust distributions apply to ESBTs.

ESBT Election

The proposed regulations provide that the ESBT election is filed with the service center where the trust files its income tax returns. The election to be a

qualified subchapter S trust (QSST) is filed with the service center where the S corporation files its income tax returns. The preamble to the proposed regulations requested comments on whether the rules for filing the QSST election should be changed so the election is filed with the service center where the trust files its returns. One commentator suggested there should be consistent filing locations for QSST elections, ESBT elections, and conversions from QSST to ESBT or ESBT to QSST. The commentator, therefore, suggested that all these documents be filed with the service center(s) where the trust and the S corporation file their returns.

The final regulations provide that the ESBT election and the election to convert from an ESBT to a QSST or from a QSST to an ESBT are all filed with the service center where the S corporation files its income tax returns. Thus, the rule in the final regulations will establish a consistent filing location for QSST and ESBT elections and conversions.

One commentator suggested that grantor trusts should be permitted to make protective ESBT elections in light of the uncertain status of some trusts that may be grantor trusts under section 674. The IRS and the Treasury Department continue to believe that a conditional ESBT election that only becomes effective in the event the trust is not a wholly-owned grantor trust should not be available. A conditional ESBT election should not be allowed because the ESBT election must have a fixed effective date. If, in the absence of a conditional ESBT election, the trust is an ineligible shareholder, relief under section 1362(f) may be available for an S corporation. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

Expedited Section 1362(f) Relief

In several contexts, commentators requested some form of expedited relief if an S corporation's election is inadvertently ineffective or is inadvertently terminated. In all these situations, the S corporation may seek relief under section 1362(f). The facts and circumstances of a particular situation are considered in determining whether relief is available, and the procedures for obtaining this relief are well established.

Effect under Section 1377 of Change in Status of a Trust

A commentator suggested that a trust's conversion to an ESBT should result in a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2) because the incidence of taxation with respect to S corporation items will change as a result of the ESBT election. The proposed regulations provide that the election would result in a termination only if, prior to the election, the trust was described in section 1361(c)(2)(A)(ii) or (iii). The commentator also recommended that the regulations address the conversion from an ESBT to another type of trust and the availability of an election under § 1.1368–1(g) to treat the S corporation's taxable year as two separate years in the case of a qualifying disposition.

The final regulations do not adopt the suggestion that all conversions of a trust to an ESBT should be treated as a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2). The final regulations expand on the rule in the proposed regulations to cover all types of conversions. Under this rule, conversion of a trust to an ESBT or a QSST does not result in the prior trust terminating its entire interest in the S corporation, unless the prior trust was described in section 1361(c)(2)(A)(ii) or (iii). When a trust described in section 1361(c)(2)(A)(ii) or (iii) converts to an ESBT or a QSST, the shareholders of the S corporation under section 1361(c)(2)(B) change from the estate of the deemed owner or testator to the PCBs of the ESBT, or the current income beneficiary of the QSST. When a trust changes from a wholly-owned grantor trust or QSST to an ESBT or from an ESBT to a QSST, the individuals who are shareholders of the S corporation under section 1361(c)(2)(B) remain the same. The election to terminate the taxable year provided in section 1377(a)(2) applies to the termination of a *shareholder's* interest in the S corporation. Accordingly, it is appropriate to treat the conversion of a trust described in section 1361(c)(2)(A)(ii) or (iii) to an ESBT or QSST as a termination of the prior trust's interest in the S corporation, but not to treat other conversions to an ESBT or QSST as terminations. The election under § 1.1368–1(g) is also not available because the conversion of the trust is not a qualifying disposition.

Section 444 Elections

One commentator suggested that the final regulations permit an S corporation to retroactively reinstate a section 444 election that it had treated as terminated by operation of § 1.444–2T(a) (prior to the issuance of the temporary regulations) as a result of an ESBT or certain tax-exempt trusts becoming a shareholder of the corporation under the auspices of the 1996 Act. The commentator believes that failure to provide such relief would result in inequitable treatment of such S corporations because, under the rules of section 444, once their elections are terminated, they are precluded from again making a section 444 election.

The IRS and the Treasury Department believe that it is appropriate to allow S corporations under these circumstances to request that the IRS disregard the termination and permit the S corporation to continue to use the same fiscal year that it used previously under section 444. However, for reasons of administrative convenience, and in order to reduce the burden on taxpayers of having to file amended returns and make retroactive payments under section 7519, the prior termination will be disregarded only at the S corporation's request, and on a prospective basis.

The final regulations provide a procedure for such requests. To illustrate the procedure, assume that, prior to 1997, an S corporation had made a section 444 election to use a taxable year ending on September 30^{th}. On January 1, 1997, an ESBT acquired a shareholder interest in the S corporation. The S corporation treated its 444 election as terminated under § 1.444–2T(a) as a result of the ESBT's shareholder interest. The S corporation changed to its required taxable year for the short period beginning October 1, 1996, and ending December 31, 1996, and filed Form 1120S, "*U.S. Income Tax Return for an S Corporation*," on the basis of a calendar year for all subsequent taxable years.

Under the final regulations, the S corporation may request that the IRS disregard the prior termination by filing Form

8716, *Election to Have a Tax Year Other Than a Required Tax Year*, with the appropriate Service Center by October 15, 2002, and by designating on the form "CONTINUATION OF SECTION 444 ELECTION UNDER § 1.444–4." The Form 8716 must indicate that under the S corporation's prior section 444 election, it used a taxable year ending September 30th. The request will be effective for the taxable year beginning January 1, 2002. No amended returns, no retroactive payments under section 7519, and no returns under § 1.7519–2T(a) for previous years in which the S corporation used its required year are required as a result of the request. Moreover, the S corporation need not make a required payment under section 7519 for its taxable year ending September 30, 2002; its first required payment for the taxable year beginning October 1, 2002, is due on May 15, 2003. The S corporation will be required to file a return under § 1.7519–2T for each taxable year beginning on or after January 1, 2002.

Effective Dates

The portion of the regulations involving the taxation of the grantor, S, and non-S portions of an ESBT was proposed to be applicable for taxable years of ESBTs that end on or after December 29, 2000, the date that the proposed regulations were published in the **Federal Register**. The remainder of the regulations involving ESBTs was proposed to be applicable on or after the date that final regulations are published in the **Federal Register**. Several commentators expressed concerns about the proposed applicability with regard to the taxation of the grantor portion of an ESBT. One commentator suggested that the proposed effective date discriminated against trusts with a situs in Guam. Others suggested that the rules regarding taxation of the grantor portion should not be applicable before the date the final regulations are published. One commentator suggested that these rules should only apply either to trusts created after the final regulations are published or after a substantial transition period.

The IRS and the Treasury Department believe that the applicable date for the rules concerning the taxation of an ESBT with a grantor portion is reasonable and appropriate. These rules do not discriminate against trusts with a particular situs because they apply to all trusts wherever situated. In the case of a grantor trust that made an ESBT election, the tax treatment of the grantor portion set forth in the proposed regulations may be different from the tax treatment that the trust and the grantor had thought was available. The proposed regulations, however, were published before the end of the 2000 taxable year and before income from that taxable year was required to be included on any person's income tax return. Thus, prior to the filing of income tax returns for 2000, it was known that the income from the grantor portion of the trust was to be taken into account by the deemed owner, not by the trust. In some situations, the trust, rather than the deemed owner, may have made estimated tax payments. Recognizing that the payment of estimated tax by the trust might subject the deemed owner to a penalty for underpayment of estimated taxes, the IRS and the Treasury Department provided relief by issuing Notice 2001–25, 2001–1 C.B. 941. That Notice provides procedures for a trust to elect to have its estimated tax payments credited to the account of the deemed owner and provides that, for purposes of calculating any underpayment of estimated tax, income attributable to the S corporation was to be taken into account on the last day of the deemed owner's 2000 taxable year.

Some commentators were concerned that existing ESBTs with currently exercisable, broad powers of appointments have resulted in S corporations exceeding the shareholder limit and have caused the termination of the S corporations' elections. The regulations regarding the definition of PCBs are applicable only for taxable years of ESBTs that begin on or after May 14, 2002. Therefore, persons who may receive a distribution from an ESBT pursuant to a currently exercisable power of appointment will not be considered PCBs of the ESBT until the first day of the ESBT's first taxable year that begins on or after May 14, 2002, and the S corporation's election will not terminate before that date. In addition, under section 1361(e)(2) if the trust disposes of all its stock in the S corporation within 60 days after that date, the persons, who would first meet the definition of PCBs on that date, will not be PCBs and the corporation's S status will not be affected.

One commentator was concerned by the applicability date of the regulations involving the deductibility of state and local income taxes and administrative expenses. Section 641(c)(2)(C)(iii) provides that the S portion may take into account its allocable share of state and local income taxes and administrative expenses, but only to the extent provided in the regulations. The commentator noted that before final regulations are issued there is no authority for an ESBT to deduct any of these items. Therefore, the commentator requested that trusts be allowed to rely on the regulatory provisions regarding these items for taxable years beginning after December 31, 1996. The effective date provisions have been modified based on this suggestion.

Additional Provisions

The final regulations clarify that the basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately.

Effect on other documents

The following documents are superseded for taxable years of ESBTs beginning on and after May 14, 2002.

Notice 97–12 (1997–1 C.B. 385).

Notice 97–49 (1997–2 C.B. 304).

Rev. Proc. 98–23 (1998–1 C.B. 662).

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections of information in the regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that (1) the estimated average

burden per trust in complying with the collections of information in § 1.1361–1(m) is 1 hour, and (2) the requirement for S corporations to comply with § 1.444–4(c) will affect very few taxpayers and the associated burden is minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the regulations' impact on small business.

Drafting Information

The principal authors of these regulations are Bradford Poston and James A. Quinn of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART I—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.444–4 is also issued under 26 U.S.C. 444(g). * * *

Par. 2. Section 1.444–4 is added to read as follows:

§ 1.444–4 Tiered structure.

(a) *Electing small business trusts*. For purposes of § 1.444–2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is treated as an electing small business trust under section 1361(e). An S corporation with an electing small business trust as a shareholder may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however, taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1996.

(b) *Certain tax-exempt trusts*. For purposes of § 1.444–2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a). An S corporation with a trust as a shareholder that is described in section 401(a) or section 501(c)(3), and is exempt from taxation under section 501(a) may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1997.

(c) *Certain terminations disregarded*—(1) *In general*. An S corporation that is described in this paragraph (c)(1) may request that a termination of its election under section 444 be disregarded, and that the S corporation be permitted to resume use of the year it previously elected under section 444, by following the procedures of paragraph (c)(2) of this section. An S corporation is described in this paragraph if the S corporation is otherwise qualified to make a section 444 election, and its previous election was terminated under § 1.444–2T(a) solely because —

(i) In the case of a taxable year beginning after December 31, 1996, a trust that is treated as an electing small business trust became a shareholder of such S corporation; or

(ii) In the case of a taxable year beginning after December 31, 1997, a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a) became a shareholder of such S corporation.

(2) *Procedure*—(i) *In general*. An S corporation described in paragraph (c)(1) of this section that wishes to make the request described in paragraph (c)(1) of this section must do so by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year,* and typing or printing legibly at the top of such form — "CONTINUATION OF SECTION 444 ELECTION UNDER § 1.444–4." In order to assist the Internal Revenue Service in updating the S corporation's account, on Line 5 the Box "Changing to" should be checked. Additionally, the election month indicated must be the last month of the S corporation's previously elected section 444 election year, and the effective year indicated must end in 2002.

(ii) *Time and place for filing Form 8716*. Such form must be filed on or before October 15, 2002, with the service center where the S corporation's returns of tax (Forms 1120S) are filed. In addition, a copy of the Form 8716 should be attached to the S corporation's short period Federal income tax return for the first election year beginning on or after January 1, 2002.

(3) *Effect of request*—(i) *Taxable years beginning on or after January 1, 2002*. An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will be permitted to resume use of the year it previously elected under section 444, commencing with its first taxable year beginning on or after January 1, 2002. Such S corporation will be required to file a return under § 1.7519–2T for each taxable year beginning on or after January 1, 2002. No payment under section 7519 will be due with respect to the first taxable year beginning on or after January 1, 2002. However, a required payment will be due on or before May 15, 2003, with respect to such S corporation's second continued section 444 election year that begins in calendar year 2002.

(ii) *Taxable years beginning prior to January 1, 2002*. An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will not be required to amend any prior Federal income tax returns, make any required payments under section 7519, or file any returns under § 1.7519–2T, with respect to taxable years beginning on or after the date the termination of its section 444 election was effective and prior to January 1, 2002.

(iii) *Section 7519: required payments and returns*. The Internal Revenue Service waives any requirement for an S corporation described in paragraph (c)(1) of this section to file the federal tax returns and make any required payments under section 7519 for years prior to the taxable

year of continuation as described in paragraph (c)(3)(i) of this section, if for such years the S corporation filed its Federal income tax returns on the basis of its required taxable year.

§ 1.444–4T [Removed]

Par. 3. Section 1.444–4T is removed.

Par. 4. Sections 1.641(c)–0 and 1.641(c)–1 are added to read as follows:

§ 1.641(c)–0 Table of contents.

This section lists the major captions contained in § 1.641(c)–1.

§ 1.641(c)–1 Electing small business trust.

§ 1.641(c)–1 Electing small business trust.

(a) *In general.* An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. See § 1.1361–1(m).

(b) *Definitions*—(1) *Grantor portion.* The grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E.

(2) *S portion.* The S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(3) *Non-S portion.* The non-S portion of an ESBT is the portion of the trust that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(c) *Taxation of grantor portion.* The grantor or another person who is treated as the owner of a portion of the ESBT includes in computing taxable income items of income, deductions, and credits against tax attributable to that portion of the ESBT under section 671.

(d) *Taxation of S portion*—(1) *In general.* The taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.

(2) *Section 1366 amounts*—(i) *In general.* The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361–1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

(ii) *Special rule for charitable contributions.* If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust' governing instrument within the meaning of section 642(c)(1) . The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

(iii) *Multiple S corporations.* If an ESBT owns stock in more than one S corporation, items of income, loss, deduction, or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income.

(3) *Gains and losses on disposition of S stock*—(i) *In general.* The S portion takes into account any gain or loss from the disposition of S corporation stock. No deduction is allowed under section 1211(b)(1) and (2) for capital losses that exceed capital gains.

(ii) *Installment method.* If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the income recognized under this method is taken into account by the S portion. See paragraph (g)(3) of this section for the treatment of interest on the installment obligation. See § 1.1361–1(m)(5)(ii) regarding treatment of a trust as an ESBT upon the sale of all S corporation stock using the installment method.

(iii) *Distributions in excess of basis.* Gain recognized under section 1368(b)(2) from distributions in excess of the ESBT's basis in its S corporation stock is taken into account by the S portion.

(4) *State and local income taxes and administrative expenses*—(i) *In general.* State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion in accordance with paragraph (h) are taken into account by the S portion.

(ii) *Special rule for certain interest.* Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

(e) *Tax rates and exemption of S portion*—(1) *Income tax rate.* Except for capital gains, the highest marginal trust rate provided in section 1(e) is applied to the taxable income of the S portion. See section 1(h) for the rates that apply to the S portion's net capital gain.

(2) *Alternative minimum tax exemption.* The exemption amount of the S portion under section 55(d) is zero.

(f) *Adjustments to basis of stock in the S portion under section 1367.* The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) *Taxation of non-S portion*—(1) *In general.* The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code. The non-S portion may consist of more than one share pursuant to section 663(c).

(2) *Dividend income under section 1368(c)(2).* Any dividend income within the meaning of section 1368(c)(2) is includible in the gross income of the non-S portion.

(3) *Interest on installment obligations.* If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion. See paragraph (d)(3)(ii) of this section for the treatment of income from such a sale or disposition.

(4) *Charitable deduction.* For purposes of applying section 642(c)(1) to payments made by the trust for a charitable purpose, the amount of gross income of the trust is limited to the gross income of the non-S portion. See paragraph (d)(2)(ii) of this section for special rules concerning charitable contributions paid by the S corporation that are deemed to be paid by the S portion.

(h) *Allocation of state and local income taxes and administration expenses.* Whenever state and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

(i) *Treatment of distributions from the trust.* Distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are deductible under section 651 or 661 in determining the taxable income of the non-S portion, and are includible in the gross income of the beneficiaries under section 652 or 662. However, the amount of the deduction or inclusion cannot exceed the amount of the distributable net income of the non-S portion. Items of income, loss, deduction, or credit taken into account by the grantor portion or the S portion are excluded for purposes of determining the distributable net income of the non-S portion of the trust.

(j) *Termination or revocation of ESBT election.* If the ESBT election of the trust terminates pursuant to § 1.1361–1(m)(5) or the ESBT election is revoked pursuant to § 1.1361–1(m)(6), the rules contained in this section are thereafter not applicable to the trust. If, upon termination or revocation, the S portion has a net operating loss under section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

(k) *Effective date.* This section generally is applicable for taxable years of ESBTs beginning on and after May 14, 2002. However, paragraphs (a), (b), (c), and (l) *Example 1* of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000. ESBTs may apply paragraphs (d)(4) and (h) of this section for taxable years of ESBTs beginning after December 31, 1996.

(l) *Examples.* The following examples illustrate the rules of this section:

Example 1. Comprehensive example. (i) Trust has a valid ESBT election in effect. Under section 678, *B* is treated as the owner of a portion of Trust consisting of a 10% undivided fractional interest in Trust. No other person is treated as the owner of any other portion of Trust under subpart E. Trust owns stock in *X*, an S corporation, and in *Y*, a C corporation. During 2000, Trust receives a distribution from *X* of $5,100, of which $5,000 is applied against Trust's adjusted basis in the *X* stock in accordance with section 1368(c)(1) and $100 is a dividend under section 1368(c)(2). Trust makes no distributions to its beneficiaries during the year.

(ii) For 2000, Trust has the following items of income and deduction:

Ordinary income attributable to *X* under section 1366Y	$5,000
Dividend income from *Y*	$900
Dividend from *X* representing C corporation earnings and profits	$100
Total trust income	$6,000
Charitable contributions attributable to *X* under section 1366	$300
Trustee fees	$200
State and local income taxes	$100

(iii) Trust's items of income and deduction are divided into a grantor portion, an S portion, and a non-S portion for purposes of determining the taxation of those items. Income is allocated to each portion as follows:

B must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:

Ordinary income from *X*	$500
Dividend income from *Y*	$90
Dividend income from *X*	$10
Total grantor portion income	$600

The total income of the S portion is $4,500, determined as follows:

Ordinary income from *X*	$5,000
Less: Grantor portion	($500)
Total S portion income	$4,500

The total income of the non-S portion is $900 determined as follows:

Dividend income from *Y* (less grantor portion)	$810
Dividend income from *X* (less grantor portion)	$90
Total non-S portion income	$900

(iv) The administrative expenses and the state and local income taxes relate to all three portions and under state law would be allocated ratably to the $6,000 of trust income. Thus, these items would be allocated 10% (600/6000) to the grantor portion, 75% (4500/6000) to the S portion and 15% (900/6000) to the non-S portion.

(v) *B* must take into account the following deductions attributable to the grantor portion of the trust:

Charitable contributions from *X*	$30
Trustee fees	$20
State and local income taxes	$10

(vi) The taxable income of the S portion is $4,005, determined as follows:

Ordinary income from *X*	$4,500
Less: Charitable contributions from X (less grantor portion)	($270)
75% of trustee fees	($150)
75% of state and local income taxes	($75)
Taxable income of S portion	$4,005

(vii) The taxable income of the non-S portion is $755, determined as follows:

Dividend income from *Y*	$810
Dividend income from *X*	$90
Total non-S portion income	$900
Less: 15% of trustee fees	($30)
15% state and local income taxes	$15)
Personal exemption	($100)
Taxable income of non-S portion	$755

Example 2. Sale of S stock. Trust has a valid ESBT election in effect and owns stock in *X*, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, Trust sells all of its stock in *X* to a person who is unrelated to Trust and its beneficiaries and realizes a capital gain of $5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).

Example 3. (i) *Sale of S stock for an installment note.* Assume the same facts as in *Example 2*, except that Trust sells its stock in *X* for a $400,000 installment note payable with stated interest over ten years. After the sale, Trust does not own any S corporation stock.

(ii) *Loss on installment sale.* Assume Trust's basis in its *X* stock was $500,000. Therefore, Trust sustains a capital loss of $100,000 on the sale. Upon the sale, the S portion terminates and the excess loss, after being netted against the other items taken into account by the S portion, is made available to the entire trust as provided in section 641(c)(4).

(iii) *Gain on installment sale.* Assume Trust's basis in its *X* stock was $300,000 and that the $100,000 gain will be recognized under the installment method of section 453. Interest income will be recognized annually as part of the installment payments. The portion of the $100,000 gain recognized annually is taken into account by the S portion. However, the annual interest income is includible in the gross income of the non-S portion.

Example 4. Charitable lead annuity trust. Trust is a charitable lead annuity trust which is not treated as owned by the grantor or another person under subpart E. Trust acquires stock in *X*, an S corporation, and elects to be an ESBT. During the taxable year, pursuant to its terms, Trust pays $10,000 to a charitable organization described in section 170(c)(2). The non-S portion of Trust receives an income tax deduction for the charitable contribution under section 642(c) only to the extent the amount is paid out of the gross income of the non-S portion. To the extent the amount is paid from the S portion by distributing S corporation stock, no charitable deduction is available to the S portion.

Example 5. ESBT distributions. (i) As of January 1, 2002, Trust owns stock in *X*, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. *X* elects to be an S corporation effective January 1, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, *X* makes an $8,000 distribution to Trust, of which $3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's basis in the *X* stock under section 1368(b). The trustee of Trust makes a distribution of $4,000 to Beneficiary during 2003. For 2003, Trust's share of *X*'s section 1366 items is $5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes.

(ii) For 2003, Trust has $5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has $3,000 of distributable net income (DNI) in the non-S portion. The non-S portion of Trust receives a distribution deduction under section 661(a) of $3,000, which represents the amount distributed to Beneficiary during the year ($4,000), not to exceed the amount of DNI ($3,000). Beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.

Par. 5. Section 1.1361–0 is amended by adding entries for § 1.1361–1(j)(12) and (m) to read as follows:

§ 1.1361–0 Table of contents.

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§ 1.1361–1 S corporation defined.

* * * * *

(j) * * *

(12) Converting a QSST to an ESBT.

* * * * *

(m) Electing small business trust (ESBT).

(1) Definition.

(2) ESBT election.

(3) Effect of ESBT election.

(4) Potential current beneficiaries.

(5) ESBT terminations.

(6) Revocation of ESBT election.

(7) Converting an ESBT to a QSST.

(8) Examples.

(9) Effective date.

* * * * *

Par. 6. Section 1.1361–1 is amended by:

1. Adding paragraphs (h)(1)(vi) and (h)(3)(i)(F).
2. Adding a sentence to the beginning of paragraph (h)(3)(ii) introductory text.
3. Adding paragraph (j)(12).
4. Adding a sentence to the end of paragraph (k)(2)(i).
5. Adding paragraph (m).

The additions read as follows:

§ 1.1361–1 S corporation defined.

* * * * *

(h) * * * (1) * * *

(vi) *Electing small business trusts.* An electing small business trust (ESBT) under section 1361(e). See paragraph (m) of this section for rules concerning ESBTs including the manner of making the election to be an ESBT under section 1361(e)(3).

* * * * *

(3) * * * (i) * * *

(F) If S corporation stock is held by an ESBT, each potential current beneficiary is treated as a shareholder. However, if for any period there is no potential current beneficiary of the ESBT, the ESBT is treated as the shareholder during such period. See paragraph (m)(4) of this section for the definition of potential current beneficiary.

(ii) * * * See § 1.641(c)–1 for the rules for the taxation of an ESBT. * * *

* * * * *

(j) * * *

(12) *Converting a QSST to an ESBT.* For a trust that seeks to convert from a QSST to an ESBT, the consent of the Commissioner is hereby granted to revoke the QSST election as of the effective date of the ESBT election, if all the following requirements are met:

(i) The trust meets all of the requirements to be an ESBT under paragraph (m)(1) of this section except for the requirement under paragraph (m)(1)(iv)(A) of this section that the trust not have a QSST election in effect.

(ii) The trustee and the current income beneficiary of the trust sign the ESBT election. The ESBT election must be filed with the service center where the S corporation files its income tax return. This ESBT election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361–1(j)" and include all information otherwise required for an ESBT election under paragraph (m)(2) of this section. A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from an ESBT to a QSST within the 36-month period preceding the effective date of the new ESBT election.

(iv) The date on which the ESBT election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(k) * * *

(2) * * * (i) * * * Paragraphs (h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), and (j)(12) of this section are applicable for taxable years beginning on and after May 14, 2002.

* * * * *

(m) *Electing small business trust (ESBT)*—(1) *Definition*—(i) *General rule.* An electing small business trust (ESBT) means any trust if it meets the following requirements: the trust does not have as a beneficiary any person other than an individual, an estate, an organization described in section 170(c)(2) through (5), or an organization described in section 170(c)(1) that holds a contingent interest in such trust and is not a potential current beneficiary; no interest in the trust has been acquired by purchase; and the trustee of the trust makes a timely ESBT election for the trust.

(ii) *Qualified beneficiaries*—(A) *In general.* For purposes of this section, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust.

(B) *Distributee trusts.* A distributee trust is the beneficiary of the ESBT only if the distributee trust is an organization described in section 170(c)(2) or (3). In all other situations, any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. A distributee trust is a trust that receives or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

(C) *Powers of appointment.* A person in whose favor a power of appointment could be exercised is not a beneficiary of an ESBT until the holder of the power of appointment actually exercises the power in favor of such person.

(D) *Nonresident aliens.* A nonresident alien as defined in section 7701(b)(1)(B) is an eligible beneficiary of an ESBT. However, see paragraph (m)(4)(i) and (m)(5)(iii) of this section if the nonresident alien is a potential current beneficiary of the ESBT (which would result in an ineligible shareholder and termination of the S corporation election).

(iii) *Interests acquired by purchase.* A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other

property by purchase or in a part-gift, part-sale transaction.

(iv) *Ineligible trusts*. An ESBT does not include—

(A) Any qualified subchapter S trust (as defined in section 1361(d)(3)) if an election under section 1361(d)(2) applies with respect to any corporation the stock of which is held by the trust;

(B) Any trust exempt from tax or not subject to tax under subtitle A; or

(C) Any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(2) *ESBT election*—(i) *In general*. The trustee of the trust must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of paragraph (m)(2)(ii) of this section. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must sign the election statement. If any one of several trustees can legally bind the trust, only one trustee needs to sign the election statement. Generally, only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT. However, if the ESBT holds stock in multiple S corporations that file in different service centers, the ESBT election must be filed with all the relevant service centers where the corporations file their income tax returns. This requirement applies only at the time of the initial ESBT election; if the ESBT later acquires stock in an S corporation which files its income tax return at a different service center, a new ESBT election is not required.

(ii) *Election statement*. The election statement must include—

(A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently owns stock;

(B) An identification of the election as an ESBT election made under section 1361(e)(3);

(C) The first date on which the trust owned stock in each S corporation;

(D) The date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); and

(E) Representations signed by the trustee stating that—

(*1*) The trust meets the definitional requirements of section 1361(e)(1); and

(*2*) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1).

(iii) *Due date for ESBT election*. The ESBT election must be filed within the time requirements prescribed in paragraph (j)(6)(iii) of this section for filing a qualified subchapter S trust (QSST) election.

(iv) *Election by a trust described in section 1361(c)(2)(A)(ii) or (iii)*. A trust that is a qualified S corporation shareholder under section 1361(c)(2)(A)(ii) or (iii) may elect ESBT treatment at any time during the 2-year period described in those sections or the 16-day-and-2-month period beginning on the date after the end of the 2-year period. If the trust makes an ineffective ESBT election, the trust will continue nevertheless to qualify as an eligible S corporation shareholder for the remainder of the period described in section 1361(c)(2)(A)(ii) or (iii).

(v) *No protective election*. A trust cannot make a conditional ESBT election that would be effective only in the event the trust fails to meet the requirements for an eligible trust described in section 1361(c)(2)(A)(i) through (iv). If a trust attempts to make such a conditional ESBT election and it fails to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv), the S corporation election will be ineffective or will terminate because the corporation will have an ineligible shareholder. Relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation election termination. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

(3) *Effect of ESBT election*—(i) *General rule*. If a trust makes a valid ESBT election, the trust will be treated as an ESBT for purposes of chapter 1 of the Internal Revenue Code as of the effective date of the ESBT election..

(ii) *Employer Identification Number*. An ESBT has only one employer identification number (EIN). If an existing trust makes an ESBT election, the trust continues to use the EIN it currently uses.

(iii) *Taxable year*. If an ESBT election is effective on a day other than the first day of the trust's taxable year, the ESBT election does not cause the trust's taxable year to close. The termination of the ESBT election (including a termination caused by a conversion of the ESBT to a QSST) other than on the last day of the trust's taxable year also does not cause the trust's taxable year to close. In either case, the trust files one tax return for the taxable year.

(iv) *Allocation of S corporation items*. If, during the taxable year of an S corporation, a trust is an ESBT for part of the year and an eligible shareholder under section 1361(c)(2)(A)(i) through (iv) for the rest of the year, the S corporation items are allocated between the two types of trusts under section 1377(a). See § 1.1377–1(a)(2)(iii).

(v) *Estimated taxes*. If an ESBT election is effective on a day other than the first day of the trust's taxable year, the trust is considered one trust for purposes of estimated taxes under section 6654.

(4) *Potential current beneficiaries*—(i) *In general*. For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust.

(ii) *Grantor trusts*. If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

(iii) *Special rule for dispositions of stock*. Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a

trust disposes of all of its S corporation stock, any person who first met the definition of a potential current beneficiary during the 60-day period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

(iv) *Distributee trusts*—(A) *In general.* This paragraph (m)(4)(iv) contains the rules for determining who are the potential current beneficiaries of an ESBT if a distributee trust becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT. A distributee trust does not include a trust that is not currently in existence. For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

(B) If the distributee trust is not a trust described in section 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.

(C) If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B)(ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

(D) For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

(v) *Contingent distributions.* A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

(vi) *Currently exercisable powers of appointment*—(A) *In general.* A person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary. Thus, if any person has a lifetime power of appointment that would permit distributions from the trust to be made to more than 75 persons, the corporation's S corporation election will terminate because the number of potential current beneficiaries will exceed the 75-shareholder limit of section 1361(b)(1)(A). Also, the S corporation election will terminate if the currently exercisable power of appointment allows distributions to be made to an ineligible shareholder as defined in section 1361(b)(1)(B) and (C).

(B) *Waiver or release.* If the holder of a power of appointment permanently releases the power in a manner that is valid under applicable local law, the persons that would be potential current beneficiaries solely because of the power will not be potential current beneficiaries after the effective date of the release. An attempt to temporarily waive, release, or limit a currently exercisable power of appointment will be ignored in determining who are potential current beneficiaries of the trust.

(vii) *Number of shareholders.* Each potential current beneficiary of the ESBT, as defined in paragraphs (m)(4)(i) through (vi) of this section, is counted as a shareholder of any S corporation whose stock is owned by the ESBT. During any period in which the ESBT has no potential current beneficiaries, the ESBT is counted as the shareholder. A person is counted as only one shareholder of an S corporation even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts described in section 1361(c)(2)(A). Thus, for example, if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation. Similarly, if a husband owns stock in an S corporation and his wife is a potential current beneficiary of an ESBT that owns stock in the same S corporation, the husband and wife will be counted as one shareholder of the S corporation.

(viii) *Miscellaneous.* Payments made by an ESBT to a third party on behalf of a beneficiary are considered to be payments made directly to the beneficiary. The right of a beneficiary to assign the beneficiary's interest to a third party does not result in the third party being a potential current beneficiary until that interest is actually assigned.

(5) *ESBT terminations*—(i) *Ceasing to meet ESBT requirements.* A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT under section 1361(e). The last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.

(ii) *Disposition of S stock.* In general, a trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock. However, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.

(iii) *Potential current beneficiaries that are ineligible shareholders.* If a potential current beneficiary of an ESBT is not an eligible shareholder of a small business corporation within the meaning of section 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a nonresident alien becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, see the special rule of paragraph (m)(4)(iii) of this section. If the S corporation election terminates, relief may be available under section 1362(f).

(6) *Revocation of ESBT election.* An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter

ruling request under the appropriate revenue procedure.

(7) *Converting an ESBT to a QSST*. For a trust that seeks to convert from an ESBT to a QSST, the consent of the Commissioner is hereby granted to revoke the ESBT election as of the effective date of the QSST election, if all the following requirements are met:

(i) The trust meets all of the requirements to be a QSST under section 1361(d).

(ii) The trustee and the current income beneficiary of the trust sign the QSST election. The QSST election must be filed with the service center where the S corporation files its income tax return. This QSST election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361–1(m)" and include all information otherwise required for a QSST election under § 1.1361–1(j)(6). A separate QSST election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from a QSST to an ESBT within the 36-month period preceding the effective date of the new QSST election.

(iv) The date on which the QSST election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(8) *Examples*. The provisions of this paragraph (m) are illustrated by the following examples in which it is assumed, unless otherwise specified, that all noncorporate persons are citizens or residents of the United States:

Example 1. (i) *ESBT election with section 663(c) separate shares*. On January 1, 2003, *M* contributes S corporation stock to Trust for the benefit of *M*'s three children *A*, *B*, and *C*. Pursuant to section 663(c), each of Trust's separate shares for *A*, *B*, and *C* will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. Trust will be treated as a single ESBT and will have a single S portion taxable under section 641(c).

(ii) *ESBT acquires stock of an additional S corporation*. On February 15, 2003, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election.

(iii) *Section 663(c) shares of ESBT convert to separate QSSTs*. Effective January 1, 2004, *A*, *B*, *C*, and Trust's trustee elect to convert each separate share of Trust into a separate QSST pursuant to paragraph (m)(7) of this section. For each separate share, they file a separate election for each S corporation whose stock is held by Trust. Each separate share will be treated as a separate QSST.

Example 2. (i) *Invalid potential current beneficiary*. Effective January 1, 2003, Trust makes a valid ESBT election. On January 1, 2004, *A*, a nonresident alien, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within 60 days after January 1, 2004. As of January 1, 2004, *A* is a potential current beneficiary of Trust and therefore is treated as a shareholder of the S corporation. Because *A* is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any corporation in which Trust holds stock terminates effective January 1, 2004. Relief may be available under section 1362(f).

(ii) *Invalid potential current beneficiary and disposition of S stock*. Assume the same facts as in *Example 2* (i) except that within 60 days after January 1, 2004, trustee of Trust disposes of all Trust's S corporation stock. *A* is not considered a potential current beneficiary of Trust and therefore is not treated as a shareholder of any S corporation in which Trust previously held stock.

Example 3. *Subpart E trust*. *M* transfers stock in *X*, an S corporation, and other assets to Trust for the benefit of *B* and *B*'s siblings. *M* retains no powers or interest in Trust. Under section 678(a), *B* is treated as the owner of a portion of Trust that includes a portion of the *X* stock. No beneficiary has acquired any portion of his or her interest in Trust by purchase, and Trust is not an ineligible trust under paragraph (m)(1)(iv) of this section. Trust is eligible to make an ESBT election.

Example 4. *Subpart E trust continuing after grantor's death*. On January 1, 2003, *M* transfers stock in *X*, an S corporation, and other assets to Trust. Under the terms of Trust, the trustee of Trust has complete discretion to distribute the income or principal to *M* during *M*'s lifetime and to *M*'s children upon *M*'s death. During *M*'s life, *M* is treated as the owner of Trust under section 677. The trustee of Trust makes a valid election to treat Trust as an ESBT effective January 1, 2003. On March 28, 2004, *M* dies. Under applicable local law, Trust does not terminate on *M*'s death. Trust continues to be an ESBT after *M*'s death, and no additional ESBT election needs to be filed for Trust after *M*'s death.

Example 5. *Potential current beneficiaries and distributee trust holding S corporation stock*. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to *A* directly or to any trust created for the benefit of *A*. On January 1, 2003, *M* creates Trust-2 for the benefit of *A*. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. *A*, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the 75-shareholder limit of section 1361(b)(1)(A). Additionally, because *A* is already counted as an S corporation shareholder because of *A*'s status as a potential current income beneficiary of Trust-1, *A* is not counted again by reason of *A*'s status as the deemed owner of Trust-2.

Example 6. *Potential current beneficiaries and distributee trust not holding S corporation stock*. (i) *Distributee trust that would itself qualify as an ESBT*. Trust-1 holds stock in *X*, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to *A*, *B*, and Trust-2, a trust for the benefit of *C*, *D*, and *E*. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, *A*, *B*, *C*, *D*, and *E* are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(ii) *Distributee trust that would not qualify as an ESBT or a QSST*. Assume the same facts as in paragraph (i) of this *Example 6* except that *D* is a nonresident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, *X*'s S corporation election terminates.

(iii) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust*. Assume the same facts as in paragraph (i) of this *Example 6* except that Trust-2 is a trust treated as owned by *A* under section 676 because *A* has the power to revoke Trust-2 at any time prior to *A*'s death. On January 1, 2003, *A* dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of *A*'s death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), *A*'s estate. Thus, *B* and *A*'s estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

Example 7. *Potential current beneficiaries and powers of appointment*. *M* creates Trust for the benefit of *A*. *A* also has a currently exercisable power to appoint income or principal to anyone except *A*, *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. The potential current beneficiaries of Trust will be *A* and all other persons except for *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. This number will exceed the 75-shareholder limit of section 1361(b)(1)(A). If Trust holds S corporation stock, the corporation's S election will terminate.

(9) *Effective date*. This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002.

Par. 7. Section 1.1362–6 is amended by revising paragraph (b)(2)(iv) to read as follows:

§ 1.1362–6 Election and consents.

* * * * *

(b) * * *

(2) * * *

(iv) *Trusts*. In the case of a trust described in section 1361(c)(2)(A) (including a trust treated under section 1361(d)(1)(A) as a trust described in section 1361(c)(2)(A)(i) and excepting an electing small business trust described in section 1361(c)(2)(A)(v) (ESBT)), only the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election. When stock of the corporation is held by a trust, both husband and wife must consent to any election if the husband and wife have a community interest in the trust property. See paragraph (b)(2)(i) of this section for rules concerning community interests in S corporation stock. In the case of an ESBT, the trustee and the owner of any portion of the trust that consists of the stock in one or more S corporations under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code must consent to the S corporation election. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

* * * * *

Par. 8. Section 1.1362–7 is amended by:

1. Revising the section heading.
2. Adding a sentence to the end of paragraph (a).

The revision and addition read as follows:

§ 1.1362–7 Effective dates.

(a) * * * Section 1.1362–6(b)(2)(iv) is applicable for taxable years beginning on and after May 14, 2002.

* * * * *

Par. 9. Section 1.1377–0 is amended by adding an entry for § 1.1377–1(a)(2)(iii) to read as follows:

§ 1.1377–0 Table of contents.

* * * * *

§ 1.1377–1 Pro rata share.

(a) * * * (2) * * *

(iii) Shareholder trust conversions.

* * * * *

Par. 10. Section 1.1377–1 is amended by:

1. Adding paragraph (a)(2)(iii).
2. Adding *Example 3* to paragraph (c).

The additions read as follows:

§ 1.1377–1 Pro rata share.

(a) * * *

(2) * * *

(iii) *Shareholder trust conversions*. If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

* * * * *

(c) * * *

Example 3. Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT). (i) On January 1, 2003, Trust receives stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2003. Subsequently, the trustee and current income beneficiary of Trust elect, pursuant to § 1.1361–1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1, 2004. The taxable year of S corporation is the calendar year. In 2004, Trust's *pro rata* share of S corporation's nonseparately computed income is $100,000.

(ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated as a QSST through June 30, 2004, and Trust is treated as an ESBT beginning July 1, 2004. Pursuant to section 1377(a)(1), the *pro rata* share of S corporation income allocated to the QSST is $49,727 ($100,000 x 182 days/366 days), and the *pro rata* share of S corporation income allocated to the ESBT is $50,273 ($100,000 x 184 days/366 days).

Par. 11. Section 1.1377–3 is revised to read as follows:

§ 1.1377–3 Effective dates.

Section 1.1377–1 and 1.1377–2 apply to taxable years of an S corporation beginning after December 31, 1996, except that § 1.1377–1(a)(2)(iii), and (c) *Example 3* are applicable for taxable years beginning on and after May 14, 2002.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 12. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 13. In § 602.101, paragraph (b) is amended by adding an entry for 1.444–4 and revising the entry for 1.1361–1 in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.444–4	1545–1591
* * * * *	
1.1361–1	1545–0731 1545–1591
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved May 3, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 13, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 14, 2002, 67 F.R. 34388)

Part III. Administrative, Procedural, and Miscellaneous

Partnership Transactions Involving Long-term Contracts

Notice 2002–37

The Internal Revenue Service (IRS) and the Treasury Department (Treasury) intend to publish regulations addressing partnership transactions involving contracts accounted for under a long-term contract method of accounting.

BACKGROUND

Concurrently with this Notice, the IRS and Treasury are issuing final regulations under § 460 of the Internal Revenue Code to address a mid-contract change in taxpayer engaged in completing a contract accounted for under a long-term contract method of accounting. In general, the regulations divide the rules regarding a mid-contract change in taxpayer engaged in completing this type of contract into two categories—constructive completion transactions and step-in-the-shoes transactions. The regulations provide that a transfer described in § 721(a) of a long-term contract to a partnership and a transfer of a partnership interest are step-in-the-shoes transactions. The IRS and Treasury intend to publish regulations addressing these and other partnership transactions involving contracts accounted for under a long-term contract method of accounting. This Notice describes the special rules that will apply to such transactions.

DESCRIPTION OF REGULATIONS RELATING TO PARTNERSHIPS

The IRS and Treasury believe that step-in-the-shoes treatment generally is appropriate for contributions of contracts to partnerships in transactions subject to § 721(a). Accordingly, the contribution of a contract accounted for under a long-term contract method of accounting to a partnership in a transaction subject to § 721(a) is a step-in-the-shoes transaction.

The regulations will require a partner that contributes a contract accounted for under a long-term contract method of accounting to a partnership to increase the basis of the partnership interest by the amount of gross receipts that the partner has recognized with respect to the contract, and reduce the basis of the partnership interest by the amount of gross receipts the partner has received or reasonably expects to receive under the contract. However, the partner may not reduce the basis of the partnership interest below zero, but must recognize income to the extent that the basis of the partnership interest would be reduced below zero. The regulations will provide that, in applying a long-term contract method of accounting to the contributed contract, the partnership must reduce its total contract price (or gross contract price) by the amount of income recognized by the contributing partner. These rules follow provisions in the final mid-contract change in taxpayer regulations regarding transfers of long-term contracts in certain corporate transactions qualifying for step-in-the-shoes treatment.

Section 704(c) generally provides that income, gain, loss, or deduction attributable to property that is contributed to a partnership must be allocated to the contributing partner. The purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. The regulations will apply § 704(c) principles to income or loss attributable to a contributed contract accounted for under a long-term contract method of accounting. The amount of income or loss subject to § 704(c) will be (i) the amount that would be taken into account (under the constructive completion rules) if, immediately before the contribution of the contract to the partnership, the partner disposed of the contract for its fair market value in a fully taxable transaction, reduced by (ii) the amount of income, if any, that the partner is required to recognize as a result of the contribution. The regulations will provide additional guidance on the manner of applying § 704(c) to income or loss from a contributed contract. The regulations will provide that for periods prior to the date that the regulations are published, taxpayers must apply § 704(c) to such income or loss in any manner that reasonably accounts for the § 704(c) income or loss over the life of the contract.

Section 741 provides that gain or loss recognized on the sale or exchange of an interest in a partnership shall be considered as gain or loss from a capital asset, except as provided in § 751. Section 751(a) provides that the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or any part of the partner's interest in the partnership attributable to unrealized receivables (as defined in § 751(c)) or inventory items (as defined in § 751(d)) of the partnership shall be considered as an amount realized from the sale or exchange of property other than a capital asset. In Rev. Rul. 79–51, 1979–1 C.B. 225, the IRS ruled that where a partner sold the partner's entire interest in a partnership, amounts received in exchange for the partner's interest attributable to the value at the time of sale of the partnership's partially completed contracts, the income from which was being accounted for on the completed contract method, were taxed under § 751(a).

The transfer of an interest in a partnership engaged in a contract accounted for under a long-term contract method of accounting is a step-in-the-shoes transaction. The regulations will provide that contracts accounted for under a long-term contract method of accounting are unrealized receivables within the meaning of § 751(c). The amount of ordinary income or loss attributable to a contract under the regulations will be the amount of income or loss that the partnership would take into account (under the constructive completion rules) if, at the time of a transfer of a partnership interest or a distribution to a partner (as the case may be), the partnership disposed of the contract for its fair market value in a fully taxable transaction.

The IRS and the Treasury do not believe that step-in-the-shoes treatment is appropriate for distributions of long-term contracts by a partnership to a partner in a transaction subject to § 731(a). In these transactions, a step-in-the-shoes rule may not produce appropriate results if the partner's basis in the contract (including the

uncompleted property, if applicable) that is distributed by a partnership is not equal to the partnership's basis in the contract (including the uncompleted property, if applicable). The regulations will provide that a distribution of a contract accounted for under a long-term contract method of accounting by a partnership to a partner is a constructive completion transaction. In determining the partnership's income on the constructive completion transaction under § 1.460–4(k)(2), the fair market value of the contract will be treated as the amount paid for the contract.

Section 751(b)(1) provides that to the extent a partner receives in a distribution — (A) partnership property which is (i) unrealized receivables or (ii) inventory items which have appreciated substantially in value, in exchange for all or a part of the partner's interest in other partnership property (including money), or (B) partnership property (including money) other than property described in § 751(b)(1)(A)(i) or (ii) in exchange for all or part of the partner's interest in partnership property described in § 751 (b)(1)(A)(i) or (ii), the transaction shall be considered a sale or exchange of the property between the distributee partner and the partnership. Because the distribution of a contract accounted for under a long-term contract method of accounting is treated as a constructive completion transaction, a distribution of the contract causes the partnership to recognize all of the ordinary income or loss attributable to the contract. Although no income or loss remains in the contract after the constructive completion, the partnership may hold other assets that may cause § 751(b) to apply. Therefore, the regulations will require a partnership that distributes a contract accounted for under a long-term contract method of accounting to apply the constructive completion rules before applying the rules of § 751(b) to the distribution.

Where a partnership that holds a contract accounted for under a long-term contract method of accounting makes a distribution to a partner that has the effect of reducing that partner's share of ordinary income or loss from the contract, the regulations generally will not require a constructive completion of the entire contract. However, consistent with the general principles of subchapter K, § 751(b) may apply to such a transaction.

Section 732 determines the basis of property (other than money) distributed by a partnership to a partner. Section 734(b) provides for an adjustment to the basis of partnership property as a result of certain distributions from partnerships that have a § 754 election in effect. The regulations will provide that if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then for purposes of determining the partner's basis in the contract (including the uncompleted property, if applicable) under § 732, and the amount of any basis adjustment under § 734(b), the partnership's basis in the contract (including the uncompleted property, if applicable) immediately prior to the distribution will be the partnership's allocable contract costs (including transaction costs), increased (or decreased) by the amount of income (or loss) recognized by the partnership on the contract through the date of the distribution (including amounts recognized as a result of the constructive completion), and decreased by the amounts that the partnership has received or reasonably expects to receive under the contract.

In addition, the regulations will provide that if a contract accounted for under a long-term contract method of accounting is distributed to a partner, then, in computing the total contract price for the new contract under § 1.460–4(k)(2)(iii), the partner's basis in the contract (including the uncompleted property, if applicable) after the distribution (as determined under § 732) will be deemed to be the consideration paid by the partner for the contract. Thus, the total contract price of the new contract will be reduced by the partner's basis in the contract (including the uncompleted property, if applicable) immediately after the distribution.

EFFECTIVE DATES

The regulations will be effective for contributions of long-term contracts to partnerships, distributions by partnerships engaged in long-term contracts, and transfers of interests in partnerships that are engaged in long-term contracts occurring on or after May 15, 2002.

REQUEST FOR PUBLIC COMMENT

Comments are requested on the scope and substance of the regulations. Direct all written comments to Internal Revenue Service, Attn: CC:ITA:RU (NT 2002–37), Room 5226, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered Monday through Friday between the hours of 8:00 a.m. and 5:00 p.m. to: CC:ITA:RU (NT 2002–37), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or submitted electronically to: *Notice.Comments@m1.irs.counsel.treas.gov*. Please submit all comments by August 12, 2002. All submissions will be open to public inspection.

DRAFTING INFORMATION

The principal author of this Notice is Richard T. Probst of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from Treasury and the IRS participated in its development. For further information regarding this Notice, contact Mr. Probst at (202) 622–3060 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, § 172.)

Rev. Proc. 2002–40

SECTION 1. PURPOSE

.01 The Job Creation and Worker Assistance Act of 2002 (the Act) added § 172(b)(1)(H) to the Internal Revenue Code to provide a 5-year carryback period for net operating losses (NOLs) for any taxable year ending during 2001 and 2002. Pub. L. No. 107–147, § 102(a), 116 Stat. 21 (March 9, 2002). Consistent with the intent of Congress as reflected in correspondence to the Treasury Department subsequent to the Act's enactment, this revenue procedure provides qualifying taxpayers who filed returns for a taxable year ending during 2001 and 2002 without taking advantage of the new 5-year carryback with a limited opportunity to

do so and to apply for a tentative carryback adjustment if they act on or before October 31, 2002.

.02 Specifically, this revenue procedure allows taxpayers that incurred an NOL in a taxable year ending during 2001 or 2002 and elected under § 172(b)(3) to forgo the NOL carryback period to revoke their elections in order to apply the 5-year carryback period. This revenue procedure also allows such taxpayers, as well as taxpayers who used a 2-year carryback period for an NOL in a taxable year ending during 2001 or 2002, to file an application for a tentative carryback adjustment under § 6411(a) based on a 5-year NOL carryback period even if the 12-month period for filing such an application has expired. A revocation and/or application for tentative carryback adjustment under this revenue procedure must be made on or before October 31, 2002. Finally, this revenue procedure allows taxpayers that filed returns for a taxable year ending in 2001 or 2002, and who neither elected to forgo the carryback period, nor used the 2-year carryback period, to elect to relinquish the 5-year carryback period (and thereby retain the ability to use the 2-year carryback period) if they act on or before October 31, 2002.

.03 In connection with these rules allowing taxpayers to reevaluate options regarding the carryback period, the Internal Revenue Service and Treasury Department intend to provide relief for consolidated groups that failed to waive the portion of the carryback period for consolidated net operating losses attributable to certain acquired members for which such members were members of another group. The scope of such relief will be announced shortly in separate guidance.

SECTION 2. BACKGROUND

.01 Section 172(b)(1)(A)(i) generally provides that an NOL for any taxable year must be carried back to each of the 2 years preceding the taxable year of such NOL. Section 172(b)(3) provides that any taxpayer entitled to a carryback period under § 172(b)(1) may elect to relinquish the carryback period with respect to an NOL for any taxable year.

.02 Section 102 of the Act amended § 172 of the Code in two respects. First, § 172(b)(1)(H) was added to allow a 5-year carryback period for NOLs for any taxable year ending during 2001 and 2002. Second, § 172(j) was added to allow any taxpayer entitled to the 5-year carryback under § 172(b)(1)(H) from any loss year to elect to relinquish that carryback period with respect to an NOL for any taxable year. A taxpayer making this election generally must apply the 2-year carryback period set forth in § 172(b)(1)(A)(i).

.03 An election to relinquish either the NOL carryback period in general under § 172(b)(3), or just the 5-year carryback period under § 172(j), must be made by the due date (including extensions) for filing the taxpayer's return for the taxable year of the NOL and in the manner prescribed by the Secretary.

.04 Section 6411(a) provides that a taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by an NOL carryback from any taxable year. Section 6411(a) also provides that the application must be filed on or after the date of filing for the return for the taxable year of the NOL from which the carryback results and within a period of 12 months after such taxable year or, with respect to any portion of a business credit carryback attributable to an NOL from a subsequent taxable year, within a period of 12 months from the end of such subsequent taxable year. Section 6411(b) provides a 90-day period during which the Service will make a limited examination of the application to discover omissions and errors of computation and determine the amount of the decrease in tax attributable to the carryback. The Service may disallow, without further action, any application that contains errors of computation that cannot be corrected within the 90-day period or that contains material omissions. The decrease in tax attributable to the carryback will be applied against unpaid amounts of tax. Any remainder of the decrease will, within the 90-day period, be credited or refunded.

.05 It has been brought to the attention of the Service and Treasury Department that some taxpayers that incurred an NOL in a taxable year ending during 2001 filed returns before the Act became law and either elected under § 172(b)(3) to relinquish the NOL carryback period in general or applied the 2-year carryback period. In some cases, these taxpayers might have wished to take advantage of the 5-year carryback period, had they been aware of its availability, and apply for a tentative carryback adjustment. The Chairmen and Ranking Members of both the House Ways and Means Committee and the Senate Finance Committee have advised the Treasury Department of their intent that qualifying taxpayers be allowed to take advantage of the 5-year NOL carryback period to the maximum extent possible, and that they intend to pursue technical corrections legislation that will clarify this intent. Specifically, the technical corrections legislation will allow the Service to issue guidance to allow taxpayers to reconsider a previous election under § 172(b)(3) to relinquish the NOL carryback period in general, and to file an application for a tentative carryback adjustment under § 6411(a), to take advantage of the 5-year carryback period, on or before October 31, 2002. When enacted, this legislation will be effective as if originally included in the Act. This revenue procedure describes how the Service is taking into account Congressional intent in administering the provision.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers that incurred an NOL for any taxable year ending in 2001 or 2002.

SECTION 4. TAXPAYERS THAT ELECTED TO FORGO THE CARRYBACK PERIOD

.01 In order to give effect to the intent of Congress to allow taxpayers a 5-year NOL carryback period, any taxpayer that previously elected under § 172(b)(3) to forgo the carryback period for an NOL for any taxable year ending in 2001 or 2002 may revoke such election in order to apply the 5-year carryback period by following the procedures of section 7 of this revenue procedure on or before October 31, 2002. Any revocation of the election to forgo the NOL carryback period will also apply to a carryback of any alternative tax NOL for the same taxable year.

.02 If a taxpayer that previously elected under § 172(b)(3) to forgo the carryback period for an NOL incurred in a taxable year ending in 2001 or 2002 does

not want to revoke that election in order to use the 5-year carryback period provided by § 172(b)(1)(H), the taxpayer need not file any additional form or statement. Unless the taxpayer follows the procedures set forth in section 7 of this revenue procedure, the taxpayer's previous election applies as well to forgo the 5-year carryback period.

SECTION 5. TAXPAYERS THAT APPLIED THE 2-YEAR CARRYBACK PERIOD

.01 If a taxpayer that previously filed an application for a tentative carryback adjustment (whether or not the Service has acted upon such application) or an amended return using a 2-year carryback period for an NOL incurred in a taxable year ending in 2001 or 2002, and that did not elect to forgo the 5-year carryback period under § 172(j), wants to use the 5-year carryback provided under § 172 (b)(1)(H), the taxpayer may do so by following the procedures of section 7 of this revenue procedure on or before October 31, 2002. Any amendment of a prior refund claim will also apply to a carryback of any alternative tax NOL for the same taxable year. In the case of an amended application for a tentative carryback adjustment, the 90-day period described in § 6411(b) will begin on the date the amended declaration is filed.

.02 If a taxpayer that previously filed an application for a tentative carryback adjustment or an amended return using a 2-year carryback period for an NOL incurred in a taxable year ending in 2001 or 2002 prefers to apply the 2-year carryback period, rather than the 5-year carryback period provided under § 172(b)(1)(H), the taxpayer need not file any form or statement in order to satisfy the requirements for an election under § 172 (j) to forgo the 5-year carryback period. Unless the taxpayer follows the procedures of section 7 of this revenue procedure, the taxpayer will be considered to have made an election under § 172(j) to forgo the 5-year carryback period in favor of the 2-year carryback period.

SECTION 6. TAXPAYERS THAT NEITHER ELECTED TO FORGO THE CARRYBACK PERIOD NOR APPLIED THE 2-YEAR CARRYBACK PERIOD

.01 Any taxpayer that:

(1) filed a federal income tax return for a taxable year ending in 2001 or 2002;

(2) did not elect under § 172(b)(3) to forgo the carryback period in general for an NOL incurred in such taxable year; and

(3) did not previously file an application for a tentative carryback adjustment or an amended return using a 2-year carryback period for such NOL, may apply the 2-year carryback period, in lieu of the 5-year carryback period, by following the procedures of section 7 of this revenue procedure on or before October 31, 2002.

.02 For any taxpayer described in section 6.01 of this revenue procedure that does not follow the procedures of section 7 of this revenue procedure to apply the 2-year carryback period, the 5-year carryback period will apply by operation of law. In that event, the period of limitations provided in § 6511 will apply in the case of any claim for refund on an amended return, and the period provided in § 6411(a) will apply in the case of any tentative carryback adjustment, that is based on the 5-year carryback period.

SECTION 7. PROCEDURES

.01 *What to File*. A taxpayer described in section 4 or 5 of this revenue procedure that wants to use the 5-year carryback period must file the appropriate form(s) using a 5-year carryback period. A taxpayer described in section 6 of this revenue procedure that wants to relinquish the 5-year carryback period (and thus retain its ability to use the 2-year carryback period) must file the appropriate form(s) using a 2-year carryback period, even if no refund or change in tax liability is shown on the form(s). The appropriate form(s) are:

(1) for corporations, a Form 1139, *Corporation Application for Tentative Refund*, or Form 1120X, *Amended U.S. Corporation Income Tax Return*;

(2) for individuals, a Form 1045, *Application for Tentative Refund*, or Form 1040X, *Amended U.S. Individual Income Tax Return*; and

(3) for estates or trusts, a Form 1045, or amended Form 1041, *U.S. Income Tax Return for Estates and Trusts*.

.02 *Labels*. Taxpayers described in section 4.01 of this revenue procedure should type or print across the top of the appropriate form "Revocation of NOL carryback waiver pursuant to Rev. Proc. 2002–40." Taxpayers described in section 5.01 of this revenue procedure should type or print across the top of the appropriate form "Amended refund claim pursuant to Rev. Proc. 2002–40."

.03 *When to File*. Any form filed pursuant to this revenue procedure must be filed on or before October 31, 2002.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective for NOLs arising in taxable years ending after December 31, 2000.

DRAFTING INFORMATION

The principal author of this revenue procedure is Martin Scully, Jr. of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Scully at (202) 622–4960 (not a toll-free call).

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26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.
(Also Part I, § 62.)

Rev. Proc. 2002–41

The purpose of this revenue procedure is to provide an optional expense substantiation rule so that businesses in the pipeline construction industry can provide reimbursements under an accountable plan to employees who also furnish welding rigs or mechanics rigs as part of their performance of services as employees. This revenue procedure is not intended to suggest that all workers providing such services and equipment are employees. Rather, the method in this revenue procedure may be applied when businesses choose to use an accountable plan to reimburse individuals who are employees for rig-related expenses incurred as employees.

As part of the Industry Issue Resolution Pilot Program, announced in Notice 2000–65, representatives of the pipeline construction industry requested clarification of the proper treatment of amounts paid to employee welders and heavy equipment mechanics who provide heavy equipment in connection with the performance of services. At issue was whether the amounts should be treated as payments of rent, payments of wages, or as the reimbursement of expenses subject to the accountable plan requirements.

Employers in the pipeline construction industry encounter several challenges to reimbursing under an accountable plan the costs relating to employee-provided welding rigs and mechanics rigs, particularly in determining the proper amount of the expense incurred. Rig welders and heavy equipment mechanics work for multiple companies for relatively short periods. Therefore, the proper allocation of fixed costs related to the equipment among employers is unclear. Moreover, although the rigs are mobile, the existing mileage-based expense substantiation provision does not accurately reflect rig-related costs because rigs are used primarily while stationary. Further, these employees incur substantial expenses as employees in providing these rigs as a condition of employment. Due to these unique features, reimbursing employees for rig-related expenses under the existing accountable plan requirements is unworkable for this industry. In order to enable this industry to reimburse rig-related expenses to employees under an accountable plan, this revenue procedure provides an optional expense substantiation rule under which rig-related expenses may be treated as substantiated when reimbursing these expenses under an accountable plan.

Under this revenue procedure an employer may pay certain welders and heavy equipment mechanics an amount of up to $13 per hour for rig-related expenses that is deemed substantiated under an accountable plan when paid in accord with this revenue procedure (up to $8 per hour if the employer provides fuel or otherwise reimburses fuel expenses). This revenue procedure provides for an annual inflation adjustment to these amounts after 2003, if necessary and is effective for payments made on or after January 1, 2003. The rules are provided in Questions and Answers below.

The Service recognizes that employers in other industries may similarly provide payments to employees for the costs of providing equipment as employees used in the performance of services as employees. To the extent that the unique features of other industries creates similar challenges to implementing accountable plans, the Service welcomes comments regarding the appropriateness and design of similar relief. We specifically request comments concerning other categories of qualified nonpersonal use vehicles owned by employees and used by the employees in the course of providing services as employees, especially where the nature of an industry results in employees working for multiple employers during each year, for which a deemed substantiation rule would be appropriate.

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reimbursed by an employer and deemed substantiated under this revenue procedure on Schedule E, Supplemental Income and Loss?

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Q-22. May an eligible employer establish an accountable plan to reimburse rig welders or heavy equipment mechanics for non-rig-related business expenses?

Q-23. May an eligible employer substitute a rig-related reimbursement for a portion of wages otherwise payable to an employee?

Q-24. What are the tax consequences if an employer that uses the deemed substantiation rule in this revenue procedure provides an additional reimbursement of rig-related expenses?

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SECTION 7. REQUEST FOR COMMENTS

SECTION 8. DRAFTING INFORMATION

SECTION 1. PURPOSE AND SCOPE

Q-1. Must an employer use this revenue procedure to reimburse employees for rig-related expenses?

A-1. No. Use of the rule described in this revenue procedure is not mandatory, and an employer may, outside the scope of this revenue procedure, reimburse actual expenses under an arrangement that meets the accountable plan requirements of § 62(c) of the Internal Revenue Code (Code) and regulations thereunder. Alternatively, an employer may reimburse employee business expenses under a nonaccountable plan (defined in Answer 6), or may choose not to reimburse employee business expenses.

Q-2. What is the tax treatment of amounts deemed substantiated under this revenue procedure?

A-2. If the other requirements described in Answer 5 are satisfied, the amounts substantiated in accordance with this revenue procedure are treated as paid under an accountable plan. Thus, the amounts are not reported as wages on Form W–2 and are exempt from the withholding and payment of income and employment taxes. Also, no return of information (*e.g.*, Form 1099) is required for payments made under an accountable plan. § 1.6041–3(h)(1).

Q-3. Which employers may use the deemed substantiation rule provided in this revenue procedure?

A-3. This substantiation rule may be used by any "eligible employer." An eligible employer is any employer that hires employee rig welders or heavy equipment mechanics and requires, as a condition of employment, that the rig welders and heavy equipment mechanics provide a welding rig or mechanics rig and use the rig in performing services as an employee employed in the construction, repair, or maintenance of transportation mainline pipeline. The business of transportation mainline pipeline construction or repair includes the construction, maintenance, or repair of transportation mainline pipeline up to the first metering station or connection. This includes mainline pipeline whether it transports coal, gas, water, or other transportable materials, vapors, or liquids. The first metering station or connection means the point where a valve, consumer connection, or town border station divides mainline transmission lines or higher pressure lateral and branch lines from lower pressure distribution systems.

Q-4. For which vehicles and equipment may eligible employers use the deemed substantiation rule provided in this revenue procedure?

A-4. Eligible employers may use the deemed substantiation rule in this revenue procedure only to reimburse employees for expenses related to the use of welding rigs and mechanics rigs described in Answer 9.

SECTION 2. BACKGROUND

Q-5. What provisions of the tax law apply when an employer reimburses an employee for employee business expenses?

A-5. The tax rules that apply when an employer reimburses an employee for employee business expenses depend upon whether the reimbursement is made under an accountable plan or nonaccountable plan. An accountable plan is a reimbursement or other expense allowance arrangement that meets three requirements under § 1.62–2: business connection, substantiation, and return of amounts in excess of substantiated expenses. The business connection requirement is satisfied if the arrangement provides advances, allowances or reimbursements only for business expenses allowable as deductions under §§ 161–198 that are paid or incurred by an employee (or that the employer reasonably expects the employee to incur) in connection with the performance of services as an employee. The substantiation requirement is satisfied if the arrangement requires each business expense to be substantiated to the employer within a reasonable period of time. The return of excess requirement is satisfied if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated. A nonaccountable plan is a reimbursement or other expenses allowance arrangement that does not satisfy one or more of the three requirements.

Q-6. What are the tax consequences to an employee when an employer reimburses expenses under a nonaccountable plan?

A-6. Generally, § 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including the trade or business of being an employee. Under § 1.62–2(c)(5), amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages on the employee's Form W–2, and are subject to withholding and payment of income and employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and income tax withholding). *See also* Employment Tax Regulations §§ 31.3121(a)–3 (FICA); 31.3306(b)–2 (FUTA); 31.3401(a)–4 (income tax withholding); and Income Tax Regulation § 1.6041–3(h)(1) (return of information exemption) (for exemption from reporting requirements for payments made under an accountable plan before January 1, 2001, see § 1.6041–3(i)(1)). The employee may still deduct the expenses. However, those deductions may

only be claimed as miscellaneous itemized deductions, which are limited by § 67 to the amount exceeding 2 percent of adjusted gross income.

Q-7. What are the tax consequences to an employee when an employer reimburses expenses under an accountable plan?

A-7. Section 1.62–2(c)(4) provides that amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W–2, and are exempt from the withholding and payment of income and employment taxes.

SECTION 3. DEEMED SUBSTANTIATION FOR RIG-RELATED EXPENSES

Q-8. What is the amount of rig-related expenses that can be deemed substantiated under this revenue procedure?

A-8. If an eligible employer either provides fuel or separately reimburses fuel expenses, expenses of up to $8 per hour for welding rigs or mechanics rigs may be deemed substantiated if the other requirements in this revenue procedure are met. If an eligible employer does not provide fuel or separately reimburse fuel expenses, rig-related expenses of up to $13 per hour for welding or mechanics rigs may be deemed substantiated if the other requirements in this revenue procedure are met.

Q-9. For what types of vehicles may rig-related expenses be deemed substantiated?

A-9. Under this revenue procedure, rig-related expenses may be deemed substantiated only with respect to welding rigs and mechanics rigs. For purposes of this revenue procedure, welding rigs are ¾ ton or heavier trucks equipped with a welding machine and other necessary equipment, such as tanks and generators. For purposes of this revenue procedure, mechanics rigs are heavy trucks equipped with a permanently installed mechanics bed and other necessary equipment that is used to repair and maintain heavy machinery on a job site. As explained in Answer 11, mechanics rigs and welding rigs are qualified nonpersonal use vehicles. The rule in this revenue procedure is not available for any other vehicles.

Q-10. May expenses be deemed substantiated for pickup trucks under this revenue procedure?

A-10. No. Expenses for pickup trucks may not be deemed substantiated as rig-related expenses under this revenue procedure unless the pickup truck is part of a welding rig as described in Answer 9. (See Rev. Proc. 2001–54 for rules under which the amount of ordinary and necessary expenses of local travel or transportation incurred by an employee will be deemed substantiated under § 1.274–5 when an employer provides a mileage allowance under an accountable plan.)

Q-11. Are welding rigs and mechanics rigs qualified nonpersonal use vehicles?

A-11. Under the authority of § 1.274–5T(k)(2)(ii)(S), the Commissioner, solely for purposes of applying the deemed substantiation rule in this revenue procedure, designates the welding rigs and mechanics rigs as described in Answer 9 as qualified nonpersonal use vehicles.

Q-12. For which employees may an eligible employer deem rig-related expenses substantiated under this revenue procedure?

A-12. An eligible employer may deem rig-related expenses substantiated only for employee rig welders and heavy equipment mechanics who are required, as a condition of employment, to provide a welding or mechanics rig for use in providing personal services as an employee.

Q-13. Under what circumstances may an eligible employer anticipate that an employee would incur rig-related expenses while performing services as an employee for an eligible employer under the deemed substantiation rule?

A-13. An eligible employer's reimbursement will meet the business connection requirement of § 1.62–2(d) if the eligible employer reasonably anticipates that the employee will incur rig-related expenses in connection with the performance of services for the employer. It would not be reasonable for an eligible employer to anticipate that an employee would incur rig-related expenses for hours that it actually knew the employee's rig was not used (such as during a work stoppage for inclement weather).

Q-14. Will the amount deemed substantiated under this revenue procedure be adjusted for inflation?

A-14. Yes. For calendar years after 2003, the hourly rate will be adjusted annually for inflation under § 1(f)(3), except that the base year for such adjustment will be calendar year 2002 and no adjustment will be made unless the increase is at least one dollar. Any adjustment will be rounded to the nearest dollar. Any adjustment to the rates provided in this revenue procedure will be published annually.

Q-15. May an independent contractor determine deductible expenses under this revenue procedure?

A-15. No. Independent contractors engaged in the trade or business of providing welding services or services as heavy equipment mechanics may not use the deemed substantiation method in this revenue procedure to determine deductible expenses in their trade or business.

SECTION 4. EMPLOYEE TREATMENT OF RIG-RELATED EXPENSES

Q-16. May an employee exclude from income amounts reimbursed and deemed substantiated under this revenue procedure?

A-16. Yes. This is true even if the amounts reimbursed and deemed substantiated exceed the actual rig-related expenses. For example, assume an employee incurs $20,000 in rig-related expenses, and the employer reimburses $20,800 at the $13 per hour rate for welding rigs provided under this revenue procedure. Because the reimbursement was paid under an accountable plan, the entire reimbursement is excluded from the employee's income.

Q-17. May an employee claim deductions for rig-related expenses that exceed amounts reimbursed under an accountable plan or deemed substantiated under this revenue procedure?

A-17. Yes. To the extent employee business expenses exceed those reimbursed under an accountable plan, they may be claimed as miscellaneous itemized deductions on Schedule A. To do this, the employee must report all reimbursed amounts, including those deemed substantiated, and must offset expenses on Form 2106.

Q-18. May an employee treat payments made under a nonaccountable plan as if they were made under an accountable plan by voluntarily substantiating expenses and returning any excess to the employer?

A-18. No. An employee cannot create an accountable plan. Under § 1.62–2(c)(3), if an employer provides a nonaccountable plan, an employee who receives payments under the plan cannot compel the employer to treat the payments as paid under an accountable plan by voluntarily substantiating the expenses or returning any excess to the employer.

Q-19. May an employee deduct any rig-related expenses that exceed those reimbursed by an employer and deemed substantiated under this revenue procedure on Schedule C, Profit or Loss From Business?

A-19. No. Expenses incurred in connection with the trade or business of being an employee may not be deducted on Schedule C.

Q-20. May an employee deduct any rig-related expenses that exceed those reimbursed by an employer and deemed substantiated under this revenue procedure on Schedule E, Supplemental Income and Loss?

A-20. No. Expenses incurred in connection with the trade or business of being an employee may not be deducted on Schedule E.

Q-21. May an employee deduct expenses that an eligible employer has already reimbursed under an accountable plan?

A-21. No.

SECTION 5. SPECIAL RULES FOR EMPLOYERS

Q-22. May an eligible employer establish an accountable plan to reimburse rig welders or heavy equipment mechanics for non-rig-related business expenses?

A-22. Yes. An employer may establish a separate accountable plan to reimburse non-rig-related employee business expenses incurred by rig welders or heavy equipment mechanics in addition to the arrangement provided under this revenue procedure. For example, Rev. Proc. 2001–47 provides rules under which an employer may establish an accountable plan for which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home will be deemed substantiated under § 1.274–54.

Q-23. May an eligible employer substitute a rig-related reimbursement for a portion of wages otherwise payable to an employee?

A-23. This revenue procedure is not intended to permit the recharacterization of wages otherwise payable to an employee. For example, if an employer normally pays an employee $35 per hour in wages and does not provide a rig reimbursement in the event of inclement weather, the employer may not recharacterize a portion of the $35 hourly wage into rig reimbursement during inclement weather. If an employer's reimbursement or other expenses allowance arrangement evidences a pattern of abuse of the accountable plan rules, then all payments made under the arrangement will be treated as paid under a nonaccountable plan.

Q-24. What are the tax consequences if an employer that uses the deemed substantiation rule in this revenue procedure provides an additional reimbursement of rig-related expenses?

A-24. If an employer that uses the deemed substantiation rule separately reimburses an employee for any rig-related expenses, the additional payment is treated as paid under a nonaccountable plan. Thus, the additional payment is reported as wages or other compensation of the employee's Form W–2, and is subject to withholding and payment of income and employment taxes.

For example, employee *A* is reimbursed for rig-related expenses deemed substantiated under this revenue procedure, and *A* incurs expenses for cleaning the rig and an oil change. The employer pays employee *A* an additional $25 per week to cover cleaning and the oil change. Because the employer also pays a rig reimbursement under this revenue procedure, the $25 paid by the employer is treated as paid under a nonaccountable plan. Thus, the additional payment is reported as wages or other compensation of the employee's Form W–2, and is subject to withholding and payment of income and employment taxes.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for payments made on or after January 1, 2003.

SECTION 7. REQUEST FOR COMMENTS

We welcome comments regarding this revenue procedure. We specifically request comments concerning other categories of qualified nonpersonal use vehicles owned by employees and used by the employees in the course of providing services as employees, especially where the nature of an industry results in employees working for multiple employers during each year, for which a deemed substantiation rule would be appropriate.

Comments regarding this revenue procedure should be sent by September 9, 2002 in writing, and should reference Rev. Proc. 2002–41. Comments can be addressed to:

CC:ITA:RU (Rev. Proc. 2002–41),
room 5226
Internal Revenue Service
POB 7604, Ben Franklin Station
Washington, DC 20044

Comments also may be hand delivered between the hours of 8 a.m. and 5 p.m. to:

CC:ITA:RU (Rev. Proc. 2002–41)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC.

Alternatively, taxpayers may transmit comments electronically via the following e-mail address:

Notice.Comments@irscounsel.treas.gov

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Joe Spires of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue procedure, call Mr. Spires at (202) 622–6040 (not a toll-free number).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Compensation Deferred Under Eligible Deferred Compensation Plans

REG–105885–99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that would provide guidance on compensation deferred under eligible section 457(b) deferred compensation plans of state and local governmental and tax-exempt entities. The regulations reflect the changes made to section 457 by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Economic Growth and Tax Relief Reconciliation Act of 2001, the Job Creation and Worker Assistance Act of 2002, and other legislation. The regulations would also make various technical changes and clarifications to the existing final regulations on many discrete issues. These regulations provide the public with guidance necessary to comply with the law and will affect plan sponsors, administrators, participants, and beneficiaries. The document also provides a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by August 7, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for August 28, 2002, must be received no later than August 7, 2002.

ADDRESSES: Send submissions to CC:ITA:RU (REG–105885–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG–105885–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, please contact Cheryl Press, (202) 622–6060 (not a toll-free number). To be placed on the attendance list for the hearing, please contact LaNita Van Dyke at (202) 622–7180 (not a toll-free number.)

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in this notice of proposed rulemaking has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1580.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to the collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On September 23, 1982, final regulations (T.D. 7836, 1982–2 C.B. 91) under section 457 of the Internal Revenue Code of 1954 (Code) were published in the **Federal Register** (47 FR 42335) (September 27, 1982) (final regulations). The final regulations provide guidance for complying with the changes to the applicable tax law made by the Revenue Act of 1978 (92 Stat. 2779) relating to deferred compensation plans maintained by state and local governments and rural electric cooperatives. These proposed regulations would amend the final regulations to conform them to the many amendments made to section 457 by subsequent legislation, including section 1107 of the Tax Reform Act of 1986 (TRA '86) (100 Stat. 2494), section 1404 of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1755) (1996), section 1071 of the Taxpayer Relief Act of 1997 (TRA '97) (111 Stat. 788) (1997), sections 615, 631, 632, 634, 635, 641, 647, 649, and other sections of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001), and paragraphs (o)(8) and (p)(5) of section 411 of the Job Creation and Worker Assistance Act of 2002 (116 Stat. 21) (2002). These proposed regulations would also amend the final regulations to provide additional guidance on section 457 issues raised since the final regulations were published in 1982. This document also incorporates the guidance provided in Notice 98–8, 1998–1 C.B. 355, with respect to amendments made to section 457 by the SBJPA and TRA '97, including the section 457(g) trust requirement for eligible plans of state and local governments (eligible governmental plans).

Explanation of Provisions

Overview

The proposed regulations would provide broad guidance regarding the rules applicable to eligible deferred compensation plans described in section 457(b) (eligible plans) and, in particular, provide clear standards for the administration and operation of eligible plans. The proposed regulations would amend the existing final regulations to update them for changes in the law, including the many changes made by EGTRRA, and respond to the comments and inquiries received from state and local governments and tax-exempt employers that sponsor eligible plans, from participants and beneficiaries, and from service providers and other advisors.

The proposed regulations at §§ 1.457–1 through 1.457–3 include a general overview of section 457, as applicable to

both eligible plans and ineligible plans that are subject to section 457(f), and general definitional provisions. Specific rules applicable to eligible plans are contained in proposed §§ 1.457–4 through 1.457–10, while rules applicable to those deferred compensation plans that fail to satisfy the requirements applicable to eligible plans (ineligible plans) are contained in proposed § 1.457–11.

1. *General provisions and establishment of eligible plans*

Section 457, as amended by TRA '86, applies to tax-exempt employers as well as to state and local governments. Eligible employers may maintain eligible plans, which must satisfy the requirements of section 457(b) in both form and operation, or may maintain ineligible plans. Benefits under eligible plans are excludable from income of plan participants until paid, in the case of an eligible governmental plan, or, in the case of an eligible plan of a tax-exempt employer, until paid or made available. Benefits under ineligible plans are, under section 457(f), includible in income when deferred or, if later, when rights to the benefits are not subject to a substantial risk of forfeiture. Certain types of plans of state and local government and tax-exempt entities are not subject to section 457. These types are listed in the definition of *plan* in proposed § 1.457–2.

The proposed regulations make clear that the requirements of section 457(b) for eligible plans apply to both elective contributions and to other types of contributions, such as mandatory contributions, nonelective employer contributions, and employer matching contributions. Thus, for example, proposed § 1.457–2(b) defines *annual deferrals* to include both elective salary reduction contributions and nonelective employer contributions. Annual deferrals also include compensation deferred under eligible plans that are defined benefit plans.

An eligible plan must satisfy the requirements of section 457(b) and related provisions both in form and in operation. Under the proposed regulations, an eligible plan must be established in writing, must include all of the material terms for benefits under the plan, and must be operated in compliance with the requirements reflected in the regulations. Of course, plan sponsors retain flexibility in determining whether to provide certain design options permitted under section 457. For example, although these proposed regulations permit certain in-service distributions of smaller account balances in accordance with section 457(e)(9), an eligible plan is not required to offer participants this distribution option. However, any optional features incorporated into an eligible plan must meet the requirements of section 457 and the regulations in both form and operation.

All amounts deferred under an eligible governmental plan are required to be set aside in a trust, custodial account, or annuity contract for the exclusive benefit of participants and their beneficiaries. However, under section 457(b)(6), all amounts deferred under an eligible plan of a tax-exempt employer are required to be unfunded. This requirement for an eligible plan of a tax-exempt employer does not alter any provision of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Accordingly, an eligible plan of a tax-exempt employer may be subject to certain of the requirements of Title I.. In the case of an eligible plan of a tax-exempt employer that is subject to Title I of ERISA, compliance with the exclusive purpose, trust, funding, and certain other rules will cause the plan to fail to satisfy section 457(b)(6). See Q&A-25 of Notice 87–13, 1987–1 C.B. 432.

The proposed regulations include certain basic rules regarding the taxation of contributions and benefits under ineligible plans, especially the relationship between deferred compensation under an ineligible plan and property transfers to which section 83 applies, but are not intended to provide complete or comprehensive guidance under section 457(f). Similarly, the proposed regulations refer to, but do not provide specific guidance on, certain arrangements that are not treated as plans providing deferred compensation, such as *bona fide* severance pay plans described in section 457(e)(11).

2. *Annual deferrals, deferral limitations, and deferral agreements under eligible plans*

a. Annual Deferrals

Proposed § 1.457–4 sets forth rules regarding deferrals under eligible plans under section 457(b). The proposed regulations would expand the rules contained in the final regulations. Examples have been included in order to illustrate the application of the rules to specific circumstances and to address common questions and situations encountered in the administration of eligible plans.

The proposed regulations use the term *annual deferrals* to describe all amounts contributed or deferred under an eligible plan, whether by voluntary salary reduction contribution or by other employer contribution, and all earnings thereon. If, as is typical, amounts contributed to the eligible plan are fully vested, the total of amounts contributed to the eligible plan during a taxable year is the same as the total of the annual deferrals for the taxable year.

The proposed regulations would also clarify that the rules concerning agreements for deferrals operate on a cash basis. Thus, under proposed § 1.457–4(b), an agreement to defer compensation is valid if it is made before the first day of the month in which compensation is paid or made available. In general, there is no requirement that the agreement be entered into prior to the time the services giving rise to the compensation are performed. However, compensation payable in the first month of employment may be deferred only if an agreement is entered into prior to the time a participant performs services for the employer. The proposed regulations provide explicitly that nonelective employer contributions are treated as being made under a valid agreement. In addition, Rev. Rul. 2000–33, 2000–2 C.B. 142, provides guidance concerning automatic enrollment under eligible plans. Contributions made under an automatic enrollment arrangement described in that Revenue Ruling may be treated as made under a valid agreement.

b. Deferral Limitations

The proposed regulations under § 1.457–4 explain the annual limits that apply to annual deferrals under eligible plans. These contribution limits are sometimes referred to as "plan ceilings." Generally, the basic annual limit or plan ceiling for a year cannot exceed a specified dollar amount for the year or, if less, 100 percent of a participant's "includible compensation." Under EGTRRA, the dollar amount is $11,000 for 2002; $12,000 for 2003; $13,000 for 2004; $14,000 for 2005; and $15,000 for 2006 and thereafter. After 2006, the $15,000 amount is adjusted for cost-of-living. As a result of the enactment of the Job Creation and Worker Assistance Act of 2002, Public Law 107–147 (116 Stat. 21) on March 9, 2002, the calculation of includible compensation is no longer reduced by the exclusions from gross income under sections 402(g), 125, 132(f), and 457. Thus, for years beginning after December 31, 2001, includible compensation is no longer reduced by elective deferrals to an eligible plan. If a participant's includible compensation is less than the applicable dollar limit, the dollar amount equal to 100 percent of includible compensation is the basic annual limit for the participant.

An eligible plan may also permit certain "catch-up" contributions. First, in accordance with section 414(v) as added to the Code by EGTRRA, a plan may allow a participant who attains age 50 by the end of the year to elect to have an additional deferral for the year. The additional amount permitted under this age 50 catch-up is $1,000 for 2002, $2,000 for 2003, $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006. Proposed regulations (REG–142499–01, 2001–45 I.R.B. 476) under section 414(v) were published in the **Federal Register** on October 23, 2001 (66 FR 53555) as § 1.414(v)–1.

Second, an eligible plan may permit a larger catch-up amount in the last three years ending before the participant attains normal retirement age. The amount of this special section 457 catch-up is two times the basic annual limit (*e.g.*, an additional $15,000 for 2006), but only to the extent the participant has not previously deferred the maximum amount under an eligible plan or similar tax-deferred retirement plan (called the underutilized amount or underutilized limitation in the proposed regulations). Alternatively, the age 50 catch-up is available in the last three years ending before the participant attains normal retirement age if the age 50 catch-up amount is larger than the special section 457 catch-up amount. Under the proposed regulations, a participant may not elect to have the special section 457 catch-up apply more than once, unless the participant is covered by a plan of another employer. If a participant also or later participates in an eligible plan of a different employer and otherwise meets the requirements for limited catch-up, the participant may elect under the new plan to have the special section 457 catch-up apply.

For purposes of the special section 457 catch-up, the proposed regulations provide that the plan must designate a normal retirement age between the age at which participants have the right to receive immediate retirement benefits under the basic pension plan of the state or tax-exempt entity without actuarial or similar reduction and age 70 ½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within these ages. The proposed regulations provide a special rule for defining normal retirement age in eligible plans of qualified police or firefighters as defined under section 415(b)(2)(H)(ii)(I), taking into account that these participants are often eligible for retirement at a younger age than other workers.

The proposed regulations require an eligible plan to set forth the plan's normal retirement age. However, as discussed in this preamble under **Proposed Effective Date**, plan amendments to reflect this requirement are not required to be adopted until guidance is issued addressing when plan amendments must be adopted.

3. *Individual limitation for combined annual deferrals under eligible plans*

Before enactment of EGTRRA, a coordination limitation applied under which the basic annual limitation and the special section 457 catch-up limitation were reduced by amounts excluded from a participant's income for any taxable year by reason of a salary reduction or elective contribution under a section 401(k) plan or a section 403(b) contract. EGTRRA eliminated coordination with section 401(k) plans and section 403(b) contracts for 2002 and thereafter. However, coordination with these types of arrangements is still taken into account for purposes of determining the underutilized amount for years before 2002, so that these rules continue to be reflected in the proposed regulations for that sole purpose.

EGTRRA did not eliminate section 457(c) under which the maximum amount excludable under all eligible plans, including eligible governmental plans and eligible plans of a tax-exempt entity, cannot exceed applicable section 457 plan limitations. Thus, these limitations, including the basic limitation, the age 50 catch-up limitation, and the special section 457 catch-up limitation, apply not only on a plan basis, but also on an individual basis for cases in which an individual participates in more than one eligible plan during a taxable year. The proposed regulations include rules for how the applicable section 457 limitations apply on an individual basis. The rules for applying catch-up limits on an individual basis provide that the special section 457 catch-up available in the last three years prior to normal retirement age is taken into account only to the extent that an annual deferral is made for a participant under an eligible plan as a result of plan provisions permitted under the special section 457 catch-up and, if the applicable catch-up amount is not the same for each such eligible plan, the individual limit is applied using the catch-up amount under whichever plan that has the largest catch-up amount applicable to the participant. However, as discussed above, a participant may not elect to have the special section 457 catch-up apply more than once, unless the participant is covered by a plan of another employer.

The proposed regulations allow an eligible governmental plan to pay out an annual deferral to the extent the deferral exceeds the individual limit or to correct a deferral in excess of the plan's limit.

4. *Sick and vacation pay deferrals*

The proposed regulations would permit an eligible plan to provide that a participant may elect to defer accumulated sick pay, accumulated vacation pay, and

back pay if certain conditions are satisfied. In accordance with section 457(b)(4), the plan must provide that these amounts may be deferred for any calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available to the participant. Thus, a participant is not permitted to elect to receive the value of accumulated sick and vacation pay on or after the date on which the employer makes that pay available to the participant in cash. Any deferrals under an eligible plan of sick and vacation pay or back pay are subject to the maximum deferral limitations of section 457 in the year of deferral. Thus, the total amount deferred for any year cannot exceed the plan ceiling for the year, taking into account the 100 percent of includible compensation limit.

5. *Excess deferrals*

The proposed regulations address the treatment of excess deferrals and the effect of excess deferrals on plan eligibility under section 457(b). The proposed regulations also provide that an eligible governmental plan may self correct excess deferrals and will not fail to satisfy the applicable requirements of the proposed regulations (including the distribution rules and the funding rules) solely by reason of a distribution of excess deferrals.

Under the proposed regulations, if an excess deferral arises under the maximum deferral limits of section 457(b) for a plan of a governmental employer, an eligible governmental plan is required to correct the failure by distributing the excess deferral to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount would be an excess deferral. If excess deferrals of this type are not distributed, the plan will be an ineligible plan with respect to which benefits are taxed according to the rules of section 457(f). If an excess deferral arises under the maximum deferral limits of section 457(b) for a plan of a tax-exempt employer, the plan is not an eligible plan. For purposes of these rules, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan.

As stated previously, while EGTRRA repealed the coordination limitation under section 457(c), EGTRRA did not eliminate the requirement that the maximum amount excludable under all eligible plans under section 457(c) as revised by EGTRRA, including eligible governmental plans and eligible plans of a tax-exempt entity, cannot exceed the applicable section 457(b) limitations. Thus, an excess deferral that results from the application of the new individual limitation for multiple eligible plans under section 457(c) may also be, but is not required to be, distributed to the participant. However, consistent with the legislative history to section 457(c), the proposed regulations make clear that a plan will not lose its status as an eligible plan by failing to distribute those excess deferrals that result from the application of this requirement (although those amounts are currently includible in the participant's income).

Comments are specifically requested concerning record-keeping requirements with respect to excess deferrals that are not distributed and, in particular, concerning the maintenance of records adequate to keep track of any previously taxed excess deferrals that remain in an eligible plan. In addition, comments are also requested as to the proper income and payroll tax reporting of distributions of excess deferrals.

6. *Minimum distribution requirements*

EGTRRA eliminated the special minimum distribution rules that applied to eligible plans. Thus, the proposed regulations generally incorporate by reference the requirements of section 401(a)(9) and the regulations thereunder concerning minimum distributions to participants and beneficiaries. Final and temporary regulations (T.D. 8987, 2002–19 I.R.B. 852) under section 401(a)(9) were published in the **Federal Register** on April 17, 2002 (67 FR 18988). These regulations provide rules for defined benefit plans and defined contribution plans. Generally, the rules for defined contribution plans apply to eligible deferred compensation plans. Beginning in 2003, a simple uniform table generally applies to all employees to determine the minimum distribution required during their lifetime, including employees covered by an eligible deferred compensation plan.[1] The one exception to this rule for lifetime distributions is for an employee with a spouse designated as the employee's sole beneficiary and the spouse is more than 10 years younger than the employee. In that case the employee can use the employee and spouse's joint and last survivor expectancy to determine the minimum distribution required during the employee's lifetime.

7. *Loans*

Proposed § 1.457–6(f) sets forth rules governing loans from eligible plans. This proposal responds to the numerous inquiries received concerning the availability of loans from eligible plans maintained by state and local governments, the assets of which are held in trust pursuant to section 457(g).

While section 457(g) does not directly address the issue of whether, or under what circumstances, loans may be made available from trusteed eligible plans, the legislative history to the SBJPA indicates that the new statutory provisions should be interpreted as permitting participant loans from the eligible plan trust under the rules applicable to loans from qualified plans. H.R. Rep. 104–737, at 251. Commentators, some citing this legislative history and some citing pre-ERISA case law and rulings interpreting the exclusive benefit requirement of section 401(a), have urged the IRS to issue formal guidance concerning loans from eligible plans. These comments take the position that the availability of loans will make savings through eligible plans more attractive to participants and will decrease the disparity between eligible plans and the other tax-favored voluntary retirement savings plans.

[1]Employees may use these new final regulations for distributions for 2002 or may use regulations proposed in 1987 or 2001.

The pre-ERISA requirements applicable to loans from qualified plans require a facts and circumstances analysis of the availability of the loan feature to all participants, the rate of return, the overall prudence of the investment of the trust corpus in the note of an individual participant, and the pattern of repayments. See, *e.g.*, *Central Motor Co. v. United States*, 583 F.2d 470, 488–491 (10th Cir. 1978); *Winger's Department Store v. Commissioner*, 82 T.C. 869 (1982); *Ma-Tran Corp. v. Commissioner*, 70 T.C. 158 (1978); and *Feroleto Steel Co. v. Commissioner*, 69 T.C. 97 (1977). See also Rev. Rul. 67–258 (1967–2 CB 68).

Under the proposed regulations, a loan from an unfunded eligible plan of a tax-exempt organization would be treated as an impermissible distribution, in violation of the requirements of section 457. However, for loans from an eligible governmental plan, the proposed regulations include a facts and circumstances general standard. This general standard is intended to apply to determine whether the loan is *bona fide* and for the exclusive purpose of benefitting participants and beneficiaries under section 457(g), as was required under pre-ERISA law for qualified plans. Among the facts and circumstances are whether the loan has a fixed repayment schedule and a reasonable interest rate, and whether there are repayment safeguards to which a prudent lender would adhere.[2] The proposed regulations require a loan to bear a reasonable rate of interest in order to satisfy the requirement that assets and income of an eligible governmental plan be held for the exclusive benefit of participants and their beneficiaries. The proposed regulations would also clarify that section 72(p) applies with respect to loans made under an eligible governmental plan. Regulations interpreting section 72(p)(2) are at § 1.72(p)–1.

If the proposed regulations are finalized in their current form, it is anticipated that the IRS will modify its current no-rule position regarding the issuance of private letter rulings to eligible plans that provide for loans.

8. *Distributions from eligible plans*

a. Eligible Governmental Plans

EGTRRA substantially altered the taxation of distributions from an eligible governmental plan by providing that amounts held under such an eligible plan are not included in a participant's or beneficiary's gross income until distributed. The proposed regulations would interpret this EGTRRA change as applying to all participants in an eligible governmental plan. Thus, an eligible governmental plan may permit participants who are currently entitled to be paid after 2001 to change their previously irrevocable payment elections.

Under EGTRRA, after 2001, the direct rollover rules applicable to qualified plans and section 403(b) contracts will apply to distributions from an eligible governmental plan. The direct rollover rules for qualified plans and section 403(b) contracts are generally explained at §§ 35.3405–1, 31.3405(c)–1, 1.401(a)(31)–1, 1.402(c)–2, and 1.402(f)–1. These direct rollover regulations have not been updated since EGTRRA to reflect that rollovers are permitted for distributions from eligible governmental plans (nor do those regulations reflect that amounts may be rolled over to eligible governmental plans after 2001).

b. Eligible Plans of Tax-Exempt Entities

Amounts deferred under an eligible plan of a tax-exempt entity continue to be taxable when paid or made available. The proposed regulations explain these rules, including the exceptions for amounts available in the event of unforeseeable emergency and distributions of smaller accounts (not in excess of $5,000).

9. *Plan terminations and plan-to-plan transfers*

The proposed regulations address the topic of plan terminations and plan-to-plan transfers. These topics have become increasingly important in light of the recent statutory changes that impose a trust requirement on eligible governmental plans. In particular, questions have been raised with respect to hospitals and other entities that change from government to private entities, whether or not tax-exempt. The direct rollovers that will be permitted by EGTRRA beginning in 2002 for eligible governmental plans provide participants affected by these types of events the ability to retain their retirement savings in a funded, tax-deferred savings vehicle by rollover to IRAs, qualified plan, or section 403(b) contracts. The proposed regulations provide a blueprint for the different plan termination and plan-to-plan transfer alternatives available to sponsors of eligible plans in these situations.

a. Plan Terminations

The proposed regulations would allow a plan to have provisions permitting plan termination whereupon amounts could be distributed without violating the distribution requirements of section 457. Under the proposed regulations, an eligible plan is terminated only if all amounts deferred under the plan are paid to participants as soon as administratively practicable. If the amounts deferred under the plan are not distributed, the plan is treated as a frozen plan and must continue to comply with all of the applicable statutory requirements necessary for plan eligibility. The proposed regulations generally follow the approach of Rev. Rul. 89–87, 1982–2 C.B. 81, which provides guidance on the termination of qualified plans. In that revenue ruling, a qualified plan under which benefit accruals have ceased is not terminated if assets of the plan remain in the plan's related trust rather than being distributed as soon as administratively feasible.

The proposed regulations also highlight the consequences to the plan in the case of an employer that ceases to be an eligible employer but fails to terminate the plan or to transfer its assets under the rules of the proposed regulations described below.

[2] See, for example, the standards in Rev. Rul. 69–494, 1969–2 C.B. 88, for determining when plan investments are primarily for the purpose of benefitting employees or their beneficiaries.

b. Plan-to-plan Transfers

The proposed regulations would clarify that transfers between certain types of eligible plans do not violate the requirements of section 457(b), including the distribution requirements of section 457(d), if certain conditions are satisfied. Thus, an eligible governmental plan may transfer its assets to another eligible governmental plan; likewise, an unfunded, tax-exempt plan may transfer amounts deferred to another unfunded, tax-exempt plan. However, in the same manner that rollovers are not permitted between unfunded plans of tax-exempt employers and funded governmental plans (and because of potential violations of the exclusive benefit rule applicable to eligible governmental plans), amounts cannot be transferred from an eligible plan of a tax-exempt employer to an eligible governmental plan or from an eligible governmental plan to an eligible plan of a tax-exempt employer.

Plan-to-plan transfers within similar types of eligible plans are permitted in two kinds of circumstances. First, it is contemplated that transfers may occur when a participant in the transferor plan terminates employment with the transferor employer and is employed by the transferee employer. Transfers with respect to individual participants are permitted if both plans agree to the transfer, the participant has terminated employment with the transferor, and the participant whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred immediately before the transfer.

Second, the proposed regulations also contemplate certain asset transfers of all amounts deferred under the plan in the event an activity of a state or local government is privatized or otherwise ceases to be performed by a governmental entity. Thus, as an alternative to plan termination or a plan-to-plan transfer, the proposed regulations provide that a government employer that loses its eligible status may transfer the eligible plan to another eligible government employer within the same state. For example, a county hospital that maintains an eligible plan and that ceases to be a governmental entity could transfer the plan to the county for continued administration.

The proposed regulations also address transfers between eligible governmental plans and qualified defined benefit plans with respect to past service credit. Because the proposed regulations specifically state that a transfer for past service credit is not treated as a distribution for purposes of section 457, such a transfer could be made while the participant is still working.

10. *Qualified domestic relations orders*

The proposed regulations address the issue of qualified domestic relations orders (QDROs). The administration of QDROs has created difficulties for eligible employers and section 457 plan administrators and participants, and numerous inquiries and private letter ruling requests involving the application of judicial domestic relations orders to participants' accounts in eligible section 457(b) deferred compensation plans have been received. The proposed regulations provide that an eligible plan may honor the terms of a QDRO without jeopardizing its eligible status.

Under the proposed regulations, as provided under section 457 as amended by EGTRRA, an eligible plan does not become an ineligible plan described in section 457(f) solely because its administrator or sponsor complies with a QDRO described in section 414(p) (taking into account the special rule section 414(p)(11) for governmental and church plans), including a QDRO requiring the distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions under § 1.457–6. In the case of an eligible governmental plan, amounts paid to the alternate payee who is the spouse or former spouse of a participant under the QDRO are taxable to the alternate payee when they are paid.

In the case of an eligible plan of a tax-exempt entity, amounts payable to the alternate payee who is the spouse or former spouse of a participant under the QDRO are taxable to the alternate payee when they are paid or made available to the alternate payee. In addition, amounts deferred under an eligible plan of a tax-exempt entity that are attributable to the alternate payee are treated as made available on the date the alternate payee is first able to receive a distribution.

11. *Rollovers to eligible plans*

EGTRRA now allows rollovers contributions to be accepted by an eligible governmental plan, but only if the receiving eligible governmental plan maintains the rollover amount in a separate account. The proposed regulations include such rollovers as part of the amount deferred under the receiving plan, but a rollover contribution is not taken into account as an annual deferral under the plan for purposes of the plan ceiling limit on annual deferrals. While EGTRRA does not require a separate account for each type of rollover contributions (*e.g.*, an account for rollovers from qualified plans which is separate from rollovers from section 403(b) contracts), comments are requested on whether there are any special characteristics applicable to qualified plans, section 403(b) contracts, or individual retirement arrangements (IRAs) under section 72(t) (imposing an additional income tax on early distributions from such plans, contracts, or arrangements) which could be lost if multiple types of separate accounts are not maintained.

12. *Correction program for section 457(b) eligible deferred compensation plans*

Employee Plans, within the Office of the Commissioner, Tax Exempt and Government Entities (TE/GE), has comprehensive correction programs for sponsors of retirement plans (qualified retirement plans, 403(b) plans, and Simplified Employee Pensions). These programs, including the Employee Plans Compliance Resolution System (EPCRS), Rev. Proc. 2001–17, 2001–1 C.B. 589, permit plan sponsors to correct plan defects and thereby continue to provide their employees retirement benefits on a tax-favored basis. Employee Plans intends to expand the provisions of EPCRS to include appropriate correction procedures for certain failures arising under eligible deferred compensation plans. The public is invited to submit comments to assist in the development of these procedures. Comments should be sent to:

Internal Revenue Service
Attention: T:EP:RA:VC
1111 Constitution Avenue, NW
Washington, D.C. 20224

Pending the update of EPCRS, submissions related to section 457 (b) eligible deferred compensation plan failures will be accepted by Employee Plans on a provisional basis outside of EPCRS.

13. *Ineligible plans*

The proposed regulations include guidance regarding ineligible plans under section 457(f). Section 457(f) was in section 457 when it was added to the Code in 1978 for governmental employees, and extended to employees of tax-exempt organizations (other than churches or certain church-controlled organizations) in 1986, because unfunded amounts held by a tax-exempt entity compound tax free like an eligible plan, a qualified plan, or a section 403(b) contract. Section 457(f) was viewed as essential in order to provide an incentive for employers that are not subject to income taxes to adopt an eligible plan, a qualified plan, or a section 403(b) contract.[3] Section 457(f) generally provides that, in the case of an agreement or arrangement for the deferral of compensation, the deferred compensation is included in gross income when deferred or, if later, when the rights to payment of the deferred compensation cease to be subject to a substantial risk of forfeiture. Section 457(f) does not apply to an eligible plan, a qualified plan, a section 403(b) contract, a section 403(c) contract, a transfer of property described in section 83, a trust to which section 402(b) applies, or a qualified governmental excess benefit arrangement described in section 415(m).

The proposed regulations reflect the statutory changes in section 457(f) that have been made since 1982—which is when the current outstanding regulations were issued—and clarify the interaction between sections 457(f) and 83 (relating to the transfer of property in connection with the performance of services). Under the proposed regulations, section 457(f) does not apply to a transfer of property if section 83 applies to the transfer. Further, section 457(f) does not apply if the date on which there is no substantial risk of forfeiture with respect to the compensation is on or after the date on which there is a transfer of property to which section 83 applies. However, section 457(f) applies if the date on which there is no substantial risk of forfeiture with respect to the compensation deferred precedes the date on which there is a transfer of property to which section 83 applies. The proposed regulations include several examples, including an example illustrating that section 457(f) does not fail to apply merely because benefits are subsequently paid by a transfer of property. Comments are requested on the coordination of section 457(f) and section 83 under these proposed regulations.

In 2000, the IRS issued Announcement 2000–1, 2000–1 C.B. 294, in which it provided interim guidance on certain broad-based, nonelective plans of a state or local government that were in existence before 1999. Comments are requested on whether similar guidance should be included in the final regulations, and, if so, how the guidance should apply to arrangements, such as those maintained by certain state or local governmental educational institutions, under which supplemental compensation is payable as an incentive to terminate employment, or as an incentive to retain retirement-eligible employees, to ensure an appropriate workforce during periods in which a temporary surplus or deficit in workforce is anticipated.

Proposed Effective Date

It is proposed that these regulations apply generally for taxable years beginning after December 31, 2001. This is the general applicability date of the changes made in section 457 by EGTRRA. Special effective date provisions apply to provisions relating to coordination of sections 457(f) and 83 and for qualified domestic relations orders. Plan amendments to reflect EGTRRA, and any other requirement under these regulations, are not required to be adopted until the later of when guidance is issued addressing when plan amendments must be adopted or the date final regulations are issued. However, employers may rely on these proposed regulations in taxable years beginning after August 20, 1996 (which is the earliest applicability date for requirements applicable to eligible plans under the SBJPA). Comments are requested on whether an applicability date later than taxable years beginning after December 31, 2001, should apply when the regulations are issued in final form.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 28, 2002, beginning at 10 a.m. in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted

[3]See generally the *Report to the Congress on the Tax Treatment of Deferred Compensation under Section 457*, Department of the Treasury, January 1992 (available from the Office of Tax Policy, Room 5315, Treasury Department, 1500 Pennsylvania Avenue, NW, Washington DC 20220).

beyond the immediate entrance more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by August 7, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Cheryl Press, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Sections 1.457–1, 1.457–2, 1.457–3, and 1.457–4 are revised to read as follows:

§ 1.457–1 General overview of section 457.

Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers as defined under § 1.457–2(d). Eligible employers can establish either deferred compensation plans that are eligible plans and that meet the requirements of section 457(b) and §§ 1.457–3 through 1.457–10, or deferred compensation plans or arrangements that do not meet the requirements of section 457(b) and §§ 1.457–3 through 1.457–10 and that are subject to tax treatment under section 457(f) and § 1.457–11.

§ 1.457–2 Definitions.

This section sets forth the definitions that are used under §§ 1.457–1 through 1.457–11.

(a) *Amount(s) deferred. Amount(s) deferred* means the total annual deferrals under an eligible plan in the current and prior years, adjusted for gain or loss. Except as otherwise specifically indicated, *amount(s) deferred* includes any rollover amount held by an eligible plan as provided under § 1.457–10(e).

(b) *Annual deferral(s)*—(1) *Annual deferral(s)* means, with respect to a taxable year, the amount of compensation deferred under an eligible plan, whether by salary reduction or by nonelective employer contribution. The amount of compensation deferred under an eligible plan is taken into account as an annual deferral in the taxable year of the participant in which deferred, or, if later, the year in which the amount of compensation deferred is no longer subject to a substantial risk of forfeiture.

(2) If the amount of compensation deferred under the plan during a taxable year is not subject to a substantial risk of forfeiture, the amount taken into account as an annual deferral is not adjusted to reflect gain or loss allocable to the compensation deferred. If, however, the amount of compensation deferred under the plan during the taxable year is subject to a substantial risk of forfeiture, the amount of compensation deferred that is taken into account as an annual deferral in the taxable year in which the substantial risk of forfeiture lapses must be adjusted to reflect gain or loss allocable to the compensation deferred until the substantial risk of forfeiture lapses.

(3) If the eligible plan is a defined benefit plan within the meaning of section 414(j), the annual deferral for a taxable year is the present value of the increase during the taxable year of the participant's accrued benefit that is not subject to a substantial risk of forfeiture (disregarding any such increase attributable to prior annual deferrals). For this purpose, present value must be determined using actuarial assumptions and methods that are reasonable (both individually and in the aggregate), as determined by the Commissioner.

(c) *Beneficiary. Beneficiary* means a beneficiary of a participant, a participant's estate, or any other person whose interest in the plan is derived from the participant, including an alternate payee as described in § 1.457–10(c).

(d) *Catch-up. Catch-up* amount or *catch-up* limitation for a participant for a taxable year means the annual deferral permitted under section 414(v) (as described in § 1.457–4(c)(2)) or section 457(b)(3) (as described in § 1.457–4(c)(3)) to the extent the amount of the annual deferral for the participant for the taxable year is permitted to exceed the plan ceiling applicable under section 457(b)(2) (as described in § 1.457–4(c)(1)).

(e) *Eligible employer. Eligible employer* means an entity that is a state as defined in paragraph (l) of this section that establishes a plan or a tax-exempt entity as defined in paragraph (m) of this section that establishes a plan. The performance of services as an independent contractor for a state or local government or a tax-exempt entity is treated as the performance of services for an eligible employer. The term *eligible employer* does not include a church as defined in section 3121(w)(3)(A), a qualified church-controlled organization as defined in section 3121(w)(3)(B), or the Federal government or any agency or instrumentality thereof.

(f) *Eligible plan*. An *eligible plan* is a plan that meets the requirements of §§ 1.457–3 through 1.457–10 that is established and maintained by an eligible employer. An *eligible governmental plan* is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (l) of this section. An arrangement does not fail to constitute a single eligible governmental plan merely because the arrangement is funded through more than one trustee, custodian, or insurance carrier. An *eligible plan of a tax-exempt entity* is an eligible plan that is established and maintained by an eligible employer as defined in paragraph (m) of this section.

(g) *Includible compensation. Includible compensation* of a participant means, with respect to a taxable year, the participant's compensation, as defined in section 415(c)(3), for services performed for the eligible employer. The amount of includible compensation is determined without regard to any community property laws.

(h) *Ineligible plan. Ineligible plan* means a plan established and maintained by an eligible employer that is not maintained in accordance with §§ 1.457–3 through 1.457–10. A plan that is not established by an eligible employer as defined in paragraph (e) of this section is neither an eligible nor an ineligible plan.

(i) *Nonelective employer contribution.* A *nonelective employer contribution* is a contribution made by an eligible employer for the participant with respect to which the participant does not have the choice to receive the contribution in cash or property. Solely for purposes of section 457 and §§ 1.457–2 through 1.457–11, the term *nonelective employer contribution* includes employer contributions that would be described in section 401(m) if they were contributions to a qualified plan.

(j) *Participant. Participant* in an eligible plan means an individual who is currently deferring compensation, or who has previously deferred compensation under the plan by salary reduction or by nonelective employer contribution and who has not received a distribution of his or her entire benefit under the eligible plan. Only individuals who perform services for the eligible employer, either as an employee or as an independent contractor, may defer compensation under the eligible plan.

(k) *Plan. Plan* includes any agreement or arrangement between an eligible employer and a participant or participants under which the payment of compensation is deferred (whether by salary reduction or by nonelective employer contribution). The following types of plan are not treated as agreements or arrangement under which compensation is deferred: a *bona fide* vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan described in section 457(e)(11)(A)(i) and any plan paying length of service awards to *bona fide* volunteers (and their beneficiaries) on account of qualified services performed by such volunteers as described in section 457(e)(11)(A)(ii). Further, the term *plan* does not include any of the following (and section 457 and §§ 1.457–2 through 1.457–11 do not apply to any of the following)—

(1) Any nonelective deferred compensation under which all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship with the eligible employer are covered under the same plan with no individual variations or options under the plan as described in section 457(e)(12), but only to the extent the compensation is attributable to services performed as an independent contractor;

(2) An agreement or arrangement described in § 1.457–11(b);

(3) Any plan satisfying the conditions in section 1107(c)(4) of the Tax Reform Act of 1986 (TRA '86) (relating to certain plans for state judges); and

(4) Any of the following plans or arrangements (to which specific transitional statutory exclusions apply)—

(i) A plan or arrangement of a tax-exempt entity in existence prior to January 1, 1987, if the conditions of section 1107(c)(3)(B) of the TRA '86, as amended by section 1011(e)(6) of Technical and Miscellaneous Revenue Act of 1988 (TAMRA), are satisfied;

(ii) A collectively bargained nonelective deferred compensation plan in effect on December 31, 1987, if the conditions of section 6064(d)(2) of TAMRA are satisfied;

(iii) Amounts described in section 6064(d)(3) of TAMRA (relating to certain nonelective deferred compensation arrangements in effect before 1989); and

(iv) Any plan satisfying the conditions in section 1107(c)(4) or (5) of TRA '86 (relating to certain plans for certain individuals with respect to which the Service issued guidance before 1977).

(l) *State. State* includes the 50 States of the United States, the District of Columbia, a political subdivision of a state or the District of Columbia, or any agency or instrumentality of a state or the District of Columbia.

(m) *Tax-exempt entity. Tax-exempt entity* includes any organization (other than a governmental unit) exempt from tax under subtitle A of the Internal Revenue Code.

(n) *Trust. Trust* means a trust described under section 457(g) and § 1.457–8. Custodial accounts and contracts described in section 401(f) are treated as trusts under the rules described in § 1.457–8(a)(2).

§ 1.457–3 General introduction to eligible plans.

(a) *Compliance in form and operation.* An eligible plan is a written plan established and maintained by an eligible employer that is maintained, in both form and operation, in accordance with the requirements of §§ 1.457–4 through 1.457–10. An eligible plan must contain all the material terms and conditions for benefits under the plan. An eligible plan may contain certain optional features not required for plan eligibility under section 457(b), such as distributions for unforeseeable emergencies, loans, plan-to-plan transfers, additional deferral elections, acceptance of rollovers to the plan, and distributions of smaller accounts to eligible participants. However, except as otherwise specifically provided in §§ 1.457–4 through 1.457–10, if an eligible plan contains any optional provisions, the optional provisions must meet, in both form and operation, the relevant requirements under section 457 and §§ 1.457–2 through 1.457–10.

(b) *Treatment as single plan.* In any case in which multiple plans are used to avoid or evade the requirements of §§ 1.457–4 through 1.457–10, the Commissioner may apply the rules under §§ 1.457–4 through 1.457–10 as if the plans were a single plan.

§ 1.457–4 Annual deferrals, deferral limitations, and deferral agreements under eligible plans.

(a) *Taxation of annual deferrals.* Annual deferrals that satisfy the requirements of paragraphs (b) and (c) of this section are excluded from the gross income of a participant in the year deferred or contributed and are not includible in gross income until paid to the participant in the case of an eligible

governmental plan, or until paid or otherwise made available to the participant in the case of an eligible plan of a tax-exempt entity. See § 1.457–7.

(b) *Agreement for deferral*. In order to be an eligible plan, the plan must provide that compensation may be deferred for any calendar month by salary reduction only if an agreement providing for the deferral has been entered into before the first day of the month in which the compensation is paid or made available. A new employee may defer compensation payable in the calendar month during which the participant first becomes an employee if an agreement providing for the deferral is entered into on or before the first day on which the participant performs services for the eligible employer. An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement. Nonelective employer contributions are treated as being made under an agreement entered into before the first day of the calendar month.

(c) *Maximum deferral limitations*—(1) *Basic annual limitation*. (i) Except as described in paragraphs (c)(2) and (3) of this section, in order to be an eligible plan, the plan must provide that the annual deferral amount for a taxable year (the plan ceiling) may not exceed the lesser of—

(A) The applicable annual dollar amount specified in section 457(e)(15): $11,000 for 2002; $12,000 for 2003; $13,000 for 2004; $14,000 for 2005; and $15,000 for 2006 and thereafter. After 2006, the $15,000 amount is adjusted for cost-of-living in the manner described in paragraph (c)(4) of this section; or

(B) 100 percent of the participant's includible compensation for the taxable year.

(ii) The amount of annual deferrals permitted by the 100 percent of includible compensation limitation under paragraph (c)(1)(i)(B) of this section is determined under section 457(e)(5) and § 1.457–2(g).

(iii) For purposes of determining the plan ceiling under this paragraph (c), the annual deferral amount does not include any rollover amounts received by the eligible plan under § 1.457–10(e).

(iv) The provisions of this paragraph (c)(1) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant A, who earns $14,000 a year, enters into a salary reduction agreement in 2006 with A's eligible employer and elects to defer $13,000 of A's compensation for that year. Participant A is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation.

(ii) *Conclusion*. The annual deferral limit for A in 2006 is the lesser of $15,000 or 100 percent of includible compensation, $14,000. A's annual deferral of $13,000 is permitted under the plan because it is not in excess of $14,000 and thus does not exceed 100 percent of A's includible compensation.

Example 2. (i) *Facts*. Assume the same facts as in *Example 1*, except that A's eligible employer provides an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under A's eligible plan. The matching contribution is equal to 100 percent of elective contributions, but not in excess of 10 percent of compensation (in A's case, $1,400).

(ii) *Conclusion*. Participant A's annual deferral exceeds the limitations of this paragraph (c)(1). A's maximum deferral limitation in 2006 is $14,000. A's salary reduction deferral of $13,000 combined with A's eligible employer's nonelective employer contribution of $1,400 exceeds the basic annual limitation of this paragraph (c)(1) because A's annual deferrals total $14,400. A has an excess deferral for the taxable year of $400, the amount exceeding A's permitted annual deferral limitation. The $400 excess deferral is treated as described in paragraph (e) of this section.

Example 3. (i) *Facts*. Beginning in year 2002, Eligible Employer X contributes $3,000 per year for five years to Participant B's eligible plan account. B's interest in the account vests in 2006. B has annual compensation of $50,000 in each of the five years 2002 through 2006. Participant B is 41 years old. B is not eligible for the catch-up described in paragraph (c)(2) or (3) of this section, participates in no other retirement plan, and has no other income exclusions taken into account in computing includible compensation. Adjusted for gain or loss, the value of B's benefit when B's interest in the account vests in 2006 is $17,000.

(ii) *Conclusion*. Under this vesting schedule, $17,000 is taken into account as an annual deferral in 2006. B's annual deferrals under the plan are limited to a maximum of $15,000 in 2006. Thus, the aggregate of the amounts deferred, $17,000, is in excess of the B's maximum deferral limitation by $2,000. The $2,000 is treated as an excess deferral described in paragraph (e) of this section.

(2) *Age 50 catch-up*—(i) *In general*. In accordance with section 414(v) and the regulations thereunder, an eligible governmental plan may provide for catch-up contributions for a participant who is age 50 by the end of the year, provided that such age 50 catch-up contributions do not exceed the catch-up limit under section 414(v)(2) for the taxable year. The maximum amount of age 50 catch-up contributions for a taxable year under section 414(v) is as follows: $1,000 for 2002; $2,000 for 2003; $3,000 for 2004; $4,000 for 2005; and $5,000 for 2006 and thereafter. After 2006, the $5,000 amount is adjusted for cost-of-living. For additional guidance, see regulations under section 414(v).

(ii) *Coordination with special section 457 catch-up*. In accordance with sections 414(v)(6)(C) and 457(e)(18), the age 50 catch-up described in this paragraph (c)(2) does not apply for any taxable year for which a higher limitation applies under the special section 457 catch-up under paragraph (c)(3) of this section. Thus, for purposes of this paragraph (c)(2)(ii) and paragraph (c)(3) of this section, the special section 457 catch-up under paragraph (c)(3) of this section applies for any taxable year if and only if the plan ceiling taking into account paragraph (c)(1) and (3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)) is larger than the plan ceiling taking into account paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding paragraph (c)(3) of this section). Thus, a participant who is eligible for the age 50 catch-up for a year and for whom the year is also one of the participant's last three taxable years ending before the participant attains normal retirement age is entitled to the larger of—

(A) The plan ceiling under paragraph (c)(1) of this section and the age 50 catch-up described in this paragraph (c)(2) (and disregarding paragraph (c)(3) of this section) or

(B) The plan ceiling under paragraphs (c)(1) and (3) of this section (and disregarding the age 50 catch-up described in this paragraph (c)(2)).

(iii) *Examples*. The provisions of this paragraph (c)(2) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant C, who is 55, is eligible to participate in an eligible governmental plan in 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) and (3) of this section and the age 50 catch-up described in this paragraph (c)(2). For 2006, C will receive compensation of $40,000 from the eligible employer. C desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section

is $15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up is $5,000 for 2006.

(ii) *Conclusion.* C is eligible for the age 50 catch-up in 2006 because C is 55 in 2006. However, C is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before C attains normal retirement age. Accordingly, the maximum that C may defer for 2006 is $20,000.

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that, in 2006, C will attain age 62. The maximum amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is $2,000 for 2006.

(ii) *Conclusion.* The maximum that C may defer for 2006 is $20,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to $15,000 and the age 50 catch-up equal to $5,000. The special section 457 catch-up under paragraph (c)(3) of this section is not applicable since it provides a smaller plan ceiling.

Example 3. (i) *Facts.* The facts are the same as in *Example 2*, except that the maximum additional amount that C can elect under the special section 457 catch-up under paragraph (c)(3) of this section is $7,000 for 2006.

(ii) *Conclusion.* The maximum that C may defer for 2006 is $22,000. This is the sum of the basic plan ceiling under paragraph (c)(1) of this section equal to $15,000, plus the additional special section 457 catch-up under paragraph (c)(3) of this section equal to $7,000. The additional dollar amount permitted under the age 50 catch-up is not applicable to C for 2006 because it provides a smaller plan ceiling.

(3) *Special section 457 catch-up*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, an eligible plan may provide that, for one or more of the participant's last three taxable years ending before the participant attains "normal retirement age," the plan ceiling is an amount not in excess of the lesser of—

(A) Twice the dollar amount in effect under paragraph (c)(1)(i)(A) of this section; or

(B) The underutilized limitation determined under paragraph (c)(3)(ii) of this section.

(ii) *Underutilized limitation.* The underutilized amount determined under this paragraph (c)(3)(ii) is the sum of—

(A) The plan ceiling established under paragraph (c)(1) of this section for the taxable year; plus

(B) The plan ceiling established under paragraph (c)(1) of this section (or under section 457(b)(2) for any year before the applicability date of this section) for any prior taxable year or years, less the amount of annual deferrals under the plan for such prior taxable year or years (disregarding any annual deferrals under the plan permitted under the age 50 catch-up under paragraph (c)(2) of this section).

(iii) *Determining underutilized limitation under paragraph (c)(3)(ii)(B) of this section.* In determining the includible compensation of a participant under § 1.457–2(g) for purposes of calculating the amount described in paragraph (c)(3)(ii)(A) of this section, includible compensation is not reduced by contributions of amounts described in paragraph (c)(3)(ii)(B) of this section. In addition, a prior taxable year is taken into account under paragraph (c)(3)(ii)(B) of this section only if it is a year beginning after December 31, 1978, in which the participant was eligible to participate in the plan, and in which compensation deferred (if any) under the plan during the year was subject to a plan ceiling established under paragraph (c)(1) of this section.

(iv) *Special rules concerning application of the coordination limit for years prior to 2002 for purposes of determining the underutilized limitation*—(A) *General rule.* For purposes of determining the underutilized limitation for years prior to 2002, participants remain subject to the rules in effect prior to the repeal of the coordination limitation under section 457(c)(2). Thus, the applicable basic annual limitation under paragraph (c)(1) of this section and the special section 457 catch-up under this paragraph (c)(3) for years in effect prior to 2002 are reduced, for purposes of determining a participant's underutilized amount under a plan, by amounts excluded from the participant's income for any prior taxable year by reason of a salary reduction or elective contribution under any other eligible section 457(b) plan, section 401(k) qualified cash or deferred arrangement, section 402(h)(1)(B) simplified employee pension (SARSEP), section 403(b) annuity contract, and section 408(p) simple retirement account, or under any plan for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18) (pre–2002 coordination plans). Similarly, in applying the section 457(b)(2)(B) limitation for includible compensation for years prior to 2002, the limitation is 33 1/3 percent of the participant's compensation includible in gross income.

(B) *Coordination limitation applied to participant.* For purposes of determining the underutilized limitation for years prior to 2002, the coordination limitation applies to pre-2002 coordination plans of all employers for whom a participant has performed services, not only to those of the eligible employer. Thus, for purposes of determining the amount excluded from a participant's gross income in any prior taxable year under paragraph (c)(3)(ii)(B) of this section, the participant's annual deferral under an eligible plan, and salary reduction or elective deferrals under all other pre-2002 coordination plans, must be determined on an aggregate basis. To the extent that the combined deferral for years prior to 2002 exceeded the maximum deferral limitations, the amount is treated as an excess deferral under paragraph (e) of this section for those prior years.

(C) *Special rule where no annual deferrals under the eligible plan.* A participant who, although eligible, did not defer any compensation under the eligible plan in any given year before 2002 is not subject to the coordinated deferral limit, even though the participant may have deferred compensation under one of the other pre-2002 coordination plans. An individual is treated as not having deferred compensation under an eligible plan for a prior taxable year if all annual deferrals under the plan are distributed in accordance with paragraph (e) of this section. Thus, to the extent that a participant participated solely in one or more of the other pre-2002 coordination plans during a prior taxable year (and not the eligible plan), the participant is not subject to the coordinated limitation for that prior taxable year. However, the participant is treated as having deferred amounts in a prior taxable year for purposes of determining the underutilized limitation for that prior taxable year under this paragraph (c)(3)(iv)(C), but only to the extent that the participant's salary reduction contributions or elective deferrals under all pre-2002 coordination plans have not exceeded the maximum deferral limitations in effect under section 457(b) for that prior taxable year. To the extent an employer did not offer an eligible plan to an individual in a prior given year, no underutilized limitation is available to the individual for that prior year, even if the

employee subsequently becomes eligible to participate in an eligible plan of the employer.

(D) *Examples*. The provisions of this paragraph (c)(3)(iv) are illustrated by the following examples:

Example 1. (i) *Facts*. In 2001 and in years prior to 2001, Participant D earned $50,000 a year and was eligible to participate in both an eligible plan and a section 401(k) plan. However, D had always participated only in the section 401(k) plan and had always deferred the maximum amount possible. For each year before 2002, the maximum amount permitted under section 401(k) exceeded the limitation of paragraph (c)(3)(i) of this section. In 2002, D is in the 3-year period prior to D's attainment of the eligible plan's normal retirement age of 65, and D now wants to participate in the eligible plan and make annual deferrals of up to $30,000 under the plan's special section 457 catch-up provisions.

(ii) *Conclusion*. Participant D is treated as having no underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the catch-up limitation under section 457(b)(3) and paragraph (c)(3) of this section because, in each of the years before 2002, D has deferred an amount in excess of the limitation of paragraph (c)(3)(i) of this section.

Example 2. (i) *Facts*. Assume the same facts as in *Example 1*, except that D only deferred $2,500 per year under the section 401(k) plan for one year before 2002.

(ii) *Conclusion*. D is treated as having an underutilized amount under paragraph (c)(3)(ii)(B) of this section for 2002 for purposes of the special section 457 catch-up limitation. This is because D has deferred an amount for prior years that is less than the limitation of paragraph (c)(1)(i) of this section.

Example 3. (i) *Facts*. Participant E, who earned $15,000 for 2000, entered into a salary reduction agreement in 2000 with E's eligible employer and elected to defer $3,000 for that year. For 2000, E's eligible employer provided an immediately vested, matching employer contribution under the plan for participants who make salary reduction deferrals under E's eligible plan. The matching contribution was equal to 100 percent of elective contributions, but not in excess of 10 percent of compensation before salary reduction deferrals (in E's case, $1,500). For 2000, E was not eligible for any catch-up contribution, participated in no other retirement plan, and had no other income exclusions taken into account in computing taxable compensation.

(ii) *Conclusion*. Participant E's annual deferral exceeded the limitations of section 457(b) for 2000. E's maximum deferral limitation in 2000 was $4,000 because E's includible compensation was $12,000 ($15,000 minus the deferral of $3,000) and the applicable limitation for 2000 was one-third of the individual's includible compensation (one-third of $12,000 equals $4,000). E's salary reduction deferral of $3,000 combined with E's eligible employer's matching contribution of $1,500 exceeded the limitation of section 457(b) for 2000 because E's annual deferrals totaled $4,500. E had an excess deferral for 2000 of $500, the amount exceeding E's permitted annual deferral limitation, and E's underutilized amount for 2000 is zero.

(v) *Normal retirement age*—(A) *General rule*. For purposes of the special section 457 catch-up in this paragraph (c)(3), a plan must specify the normal retirement age under the plan. A plan may define normal retirement age as any age that is on or after the earlier of age 65 or the age at which participants have the right to retire and receive, under the basic defined benefit pension plan of the state or tax-exempt entity, immediate retirement benefits without actuarial or similar reduction because of retirement before some later specified age, and that is not later than age 70 ½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within these ages. For purposes of the special section 457 catch-up in this paragraph (c)(3), an entity sponsoring more than one eligible plan may not permit a participant to have more than one normal retirement age under the eligible plans it sponsors.

(B) *Special rule for eligible plans of qualified police or firefighters*. An eligible plan with participants that include qualified police or firefighters as defined under section 415(b)(2)(H)(ii)(I) may designate a normal retirement age for such qualified police or firefighters that is earlier than the earliest normal retirement age designated under the general rule of paragraph (c)(3)(i)(A) of this section, but in no event may the normal retirement age be earlier than age 40. Alternatively, a plan may allow a qualified police or firefighter participant to designate a normal retirement age that is between age 40 and age 70 ½.

(vi) *Examples*. The provisions of this paragraph (c)(3) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant *F*, who will turn 61 on April 1, 2006, becomes eligible to participate in an eligible plan on January 1, 2006. The plan provides a normal retirement age of 65. The plan provides limitations on annual deferrals up to the maximum permitted under paragraphs (c)(1) through (3) of this section. For 2006, F will receive compensation of $40,000 from the eligible employer. F desires to defer the maximum amount possible in 2006. The applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section is $15,000 for 2006 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 is $5,000 for 2006.

(ii) *Conclusion*. F is not eligible for the special section 457 catch-up under paragraph (c)(3) of this section in 2006 because 2006 is not one of the last three taxable years ending before F attains normal retirement age. Accordingly, the maximum that F may defer for 2006 is $20,000. See also paragraph (c)(2)(iii) *Example 1* of this section.

Example 2. (i) *Facts*. The facts are the same as in *Example 1* except that, in 2006, F elects to defer only $2,000 under the plan (rather than the maximum permitted amount of $20,000). In addition, assume that the applicable basic dollar limit of paragraph (c)(1)(i)(A) of this section continues to be $15,000 for 2007 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be $5,000 for 2007. In F's taxable year 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, F again receives a salary of $40,000 and elects to defer the maximum amount permissible under the plan's catch-up provisions prescribed under paragraph (c) of this section.

(ii) *Conclusion*. For 2007, which is one of the last three taxable years ending before F attains the plan's normal retirement age of 65, the applicable limit on deferrals for F is the larger of the amount under the special section 457 catch-up or $20,000, which is the basic annual limitation ($15,000) and the age 50 catch-up limit of section 414(v) ($5,000). For 2007, F's special section 457 catch-up amount is the lesser of two times the basic annual limitation ($30,000) or the sum of the basic annual limitation ($15,000) plus the $13,000 underutilized limitation under paragraph (c)(3)(ii) of this section (the $15,000 plan ceiling in 2006, minus the $2,000 contributed for F in 2006), or $28,000. Thus, the maximum amount that F may defer in 2007 is $28,000.

Example 3. (i) *Facts*. The facts are the same as in *Examples 1* and *2*, except that F does not make any contributions to the plan before 2010. In addition, assume that the applicable basic dollar limitation of paragraph (c)(1)(i)(A) of this section continues to be $15,000 for 2010 and the additional dollar amount permitted under the age 50 catch-up in paragraph (c)(2) of this section for an individual who is at least age 50 continues to be $5,000 for 2010. In F's taxable year 2010, the year in which F attains age 65 (which is the normal retirement age under the plan), F desires to defer the maximum amount possible under the plan. F's compensation for 2010 is again $40,000.

(ii) *Conclusion*. For 2010, the maximum amount that F may defer is $20,000. The special section 457 catch-up provisions under paragraph (c)(3) of this section are not applicable because 2010 is not a taxable year ending before the year in which F attains normal retirement age.

(4) *Cost-of-living adjustment*. For years beginning after December 31, 2006, the $15,000 dollar limitation in paragraph (c)(1)(i)(A) of this section will be adjusted to take into account increases in the cost-of-living. The adjustment in the dollar limitation is made at the same time and in the same manner as under section 415(d) (relating to qualified plans under section 401(a)), except that the base period is the calendar quarter beginning July 1, 2005, and any increase which is

not a multiple of $500 will be rounded to the next lowest multiple of $500.

(d) *Deferral of sick, vacation, and back pay under an eligible plan*—(1) *In general*. An eligible plan may provide that a participant may elect to defer accumulated sick pay, accumulated vacation pay, and back pay under an eligible plan if certain conditions are satisfied. The plan must provide, in accordance with paragraph (b) of this section, that these amounts may be deferred for any calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month. Any deferrals made under this paragraph (d)(1) under an eligible plan are subject to the maximum deferral limitations of paragraph (c) of this section.

(2) *Examples*. The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant G, age 62, is a participant in an eligible plan providing a normal retirement age of 65. Under the terms of G's employer's eligible plan and G's sick leave plan, G may, during November of 2003 (which is one of the three years prior to normal retirement age), make a one-time election to contribute amounts representing accumulated sick pay to the eligible plan in December of 2003 (within the maximum deferral limitations). Alternatively, such amounts may remain in the "bank" under the sick leave plan. No cash out of the sick pay is available at any time prior to termination of employment. The total value of G's accumulated sick pay (determined, in accordance with the terms of the sick leave plan, by reference to G's current salary) is $4,000 in December of 2003.

(ii) *Conclusion*. Under the terms of the eligible plan and sick leave plan, G may elect before December of 2003 to defer the $4,000 value of accumulated sick pay under the eligible plan, provided that G's other annual deferrals to the eligible plan for 2003, when added to the $4,000, do not exceed G's maximum deferral limitation for the year.

Example 2. (i) *Facts*. Employer X maintains an eligible plan and a vacation leave plan. Under the terms of the vacation leave plan, employees generally accrue three weeks of vacation per year. Up to one week's unused vacation may be carried over from one year to the next, so that in any single year an employee may have a maximum of four weeks vacation time. At the beginning of each calendar year, under the terms of the eligible plan (which constitutes an agreement providing for the deferral), the value of any unused vacation time from the prior year in excess of one week is automatically contributed to the eligible plan, to the extent of the employee's maximum deferral limitations. Amounts in excess of the maximum deferral limitations are forfeited.

(ii) *Conclusion*. The value of the unused vacation pay contributed to X's eligible plan pursuant to the terms of the plan and the terms of the vacation leave plan is treated as an annual deferral to the eligible plan in the calendar year the contribution is made. No amounts contributed to the eligible plan will be considered made available to a participant in X's eligible plan.

(e) *Excess deferrals under an eligible plan*—(1) *In general*. Any amount deferred under an eligible plan for the taxable year of a participant that exceeds the maximum deferral limitations set forth in paragraphs (c)(1) through (3) of this section, and any amount that exceeds the individual limitation under § 1.457–5, constitutes an excess deferral taxable in accordance with § 1.457–11 for that taxable year. Thus, an excess deferral is includible in gross income in the taxable year deferred or, if later, the first taxable year in which there is no substantial risk of forfeiture.

(2) *Excess deferrals under an eligible governmental plan other than as a result of the individual limitation*. In order to be an eligible governmental plan, the plan must provide that any excess deferrals resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section to amounts deferred under the eligible plan (computed without regard to the individual limitation under § 1.457–5) will be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan. An eligible governmental plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or §§ 1.457–6 through 1.457–10 (including the distribution rules under § 1.457–6 and the funding rules under § 1.457–8) solely by reason of a distribution made under this paragraph (e)(2). If such excess deferrals are not corrected by distribution under this paragraph (e)(2), the plan will be an ineligible plan under which benefits are taxable in accordance with § 1.457–11.

(3) *Excess deferrals under an eligible plan of a tax-exempt employer other than as a result of the individual limitation*. If a plan of a tax-exempt employer fails to comply with the limitations of paragraphs (c)(1) through (3) of this section, the plan will be an ineligible plan under which benefits are taxable in accordance with § 1.457–11. For purposes of determining whether there is an excess deferral resulting from a failure of a plan to apply the limitations of paragraphs (c)(1) through (3) of this section, all plans under which an individual participates by virtue of his or her relationship with a single employer are treated as a single plan.

(4) *Excess deferrals arising from application of the individual limitation*. An eligible plan may provide that an excess deferral as a result of a failure to comply with the individual limitation under § 1.457–5 for a taxable year may be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. An eligible plan does not fail to satisfy the requirements of paragraphs (a) through (d) of this section or §§ 1.457–6 through 1.457–10 (including the distribution rules under § 1.457–6 and the funding rules under § 1.457–8) solely by reason of a distribution made under this paragraph (e)(4). Although a plan will still maintain eligible status if excess deferrals are not distributed under this paragraph (e)(4), a participant must include the excess amounts in income as provided in paragraph (e)(1) of this section.

(5) *Examples*. The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. (i) *Facts*. In 2006, the eligible plan of State Employer X in which Participant H participates permits a maximum deferral of the lesser of $15,000 or 100 percent of includible compensation. In 2006, H, who has compensation of $28,000, nevertheless defers $16,000 under the eligible plan. Participant H is age 45 and normal retirement age under the plan is age 65. For 2006, the applicable dollar limit under paragraph (c)(1)(i)(A) of this section is $15,000.

(ii) *Conclusion*. Participant H has deferred $1,000 in excess of the $15,000 limitation provided for under the plan for 2006. The $1,000 excess must be included by H into H's income for 2006. In order to correct the failure and still be an eligible plan, the plan must distribute the excess deferral, with allocable net income, as soon as administratively practicable after determining that the amount exceeds the plan deferral limitations. If the excess deferral is not distributed, the plan will be an ineligible plan

with respect to which benefits are taxable in accordance with § 1.457–11.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that H's deferral under the eligible plan is limited to $11,000 and H also makes a salary reduction contribution of $5,000 to an annuity contract under section 403(b) with the same Employer X.

(ii) *Conclusion*. H's deferrals are within the plan deferral limitations of Employer X. Because of the repeal of the application of the coordination limitation under former paragraph (2) of section 457(c), H's salary reduction deferrals under the annuity contract are no longer considered in determining H's applicable deferral limits under paragraphs (c)(1) through (3) of this section.

Example 3. (i) *Facts*. The facts are the same as in *Example 1*, except that H's deferral under the eligible governmental plan is limited to $14,000 and H also makes a deferral of $4,000 to an eligible governmental plan of a different employer. Participant H is age 45 and normal retirement age under both eligible plans is age 65.

(ii) *Conclusion*. Because of the application of the individual limitation under § 1.457–5, H has an excess deferral of $3,000 (the sum of $14,000 plus $4,000 equals $18,000, which is $3,000 in excess of the dollar limitation of $15,000). The $3,000 excess deferral, with allocable net income, may be distributed from either plan as soon as administratively practicable after determining that the combined amount exceeds the deferral limitations. If the $3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the $3,000 must be included by H into H's income for 2006.

Example 4. (i) *Facts*. Assume the same facts as in *Example 3*, except that H's deferral under the eligible governmental plan is limited to $14,000 and H also makes a deferral of $4,000 to an eligible plan of Employer Y, a tax-exempt entity.

(ii) *Conclusion*. The results are the same as in *Example 3*, *i.e.*, because of the application of the individual limitation under § 1.457–5, H has an excess deferral of $3,000. If the $3,000 excess deferral is not distributed to H, each plan will continue to be an eligible plan, but the $3,000 must be included by H into H's income for 2006.

Par. 3. Sections 1.457–5 through 1.457–12 are added to read as follows:

§ 1.457–5 Individual limitation for combined annual deferrals under multiple eligible plans

(a) *General rule*. The individual limitation under section 457(c) and this section equals the basic annual deferral limitation under § 1.457–4(c)(1)(i)(A), the age 50 catch-up amount under § 1.457–4(c)(2), and the special section 457 catch-up amount under § 1.457–4(c)(3), applied by taking into account the combined annual deferral for the participant for any taxable year under all eligible plans. While an eligible plan may include provisions under which it will meet the individual limitation under section 457(c) and this section, annual deferrals by a participant that exceed the individual limit under section 457(c) and this section will not cause a plan to lose its eligible status. However, to the extent the combined annual deferrals for a participant for any taxable year exceed the individual limitation under section 457(c) and this section for that year, the amounts are treated as excess deferrals as described in § 1.457–4(e).

(b) *Limitation applied to participant*. The individual limitation in this section applies to eligible plans of all employers for whom a participant has performed services, including both eligible governmental plans and eligible plans of a tax-exempt entity and both eligible plans of the employer and eligible plans of other employers. Thus, for purposes of determining the amount excluded from a participant's gross income in any taxable year (including the underutilized limitation under § 1.457–4(c)(3)(ii)(B)), the participant's annual deferral under an eligible plan, and the participant's annual deferrals under all other eligible plans, must be determined on an aggregate basis. To the extent that the combined annual deferral amount exceeds the maximum deferral limitation applicable under § 1.457–4(c)(1)(i)(A), (c)(2), or (c)(3), the amount is treated as an excess deferral under § 1.457–4(e).

(c) *Special rules for catch-up amounts under multiple eligible plans*. For purposes of applying section 457(c) and this section, the special section 457 catch-up under § 1.457–4(c)(3) is taken into account only to the extent that an annual deferral is made for a participant under an eligible plan as a result of plan provisions permitted under § 1.457–4(c)(3). In addition, if a participant has annual deferrals under more than one eligible plan and the applicable catch-up amount under § 1.457–4(c)(2) or (3) is not the same for each such eligible plan for the taxable year, section 457(c) and this section are applied using the catch-up amount under whichever plan has the largest catch-up amount applicable to the participant.

(d) *Examples*. The provisions of this section are illustrated by the following examples:

Example 1. (i) *Facts*. Participant F is age 62 in 2006 and participates in two eligible plans during 2006, Plans J and K, which are each eligible plans of two different governmental entities. Each plan includes provisions allowing the maximum annual deferral permitted under § 1.457–4(c)(1) through (3). For 2006, the underutilized amount under § 1.457–4(c)(3)(ii)(B) is $20,000 under Plan J and is $40,000 under Plan K. Normal retirement age is age 65 under both plans. Participant F defers $15,000 under each plan. Participant F's includible compensation is in each case in excess of the deferral. Neither plan designates the $15,000 contribution as a catch-up permitted under each plan's special section 457 catch-up provisions.

(ii) *Conclusion*. For purposes of applying this section to Participant F for 2006, the maximum exclusion is $20,000. This is equal to the sum of $15,000 plus $5,000, which is the age 50 catch-up amount. Thus, F has an excess amount of $10,000 which is treated as an excess deferral for Participant F for 2006 under § 1.457–4(e).

Example 2. (i) *Facts*. Participant E, who will turn 63 on April 1, 2006, participates in four eligible plans during 2006: Plan W which is an eligible governmental plan; and Plans X, Y, and Z which are each eligible plans of three different tax-exempt entities. For 2006, the limitation under these plans that apply to Participant E under all four plans under § 1.457–4(c)(1)(i)(A) is $15,000. For 2006, the additional age 50 catch-up limitation that applies to Participant E under Plan W under § 1.457–4(c)(2) is $5,000. Further, for 2006, different limitations under §§ 1.457–4(c)(3) and (c)(3)(ii)(B) apply to Participant E under each of these plans, as follows: under Plan W, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is *$7,000*; under Plan X, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is *$2,000*; under Plan Y, the underutilized limitation under § 1.457–4(c)(3)(ii)(B) is *$8,000*; and under Plan Z, § 1.457–4(c)(3) is not applicable since normal retirement age is age 62 under Plan Z. Participant E's includible compensation is in each case in excess of any applicable deferral.

(ii) *Conclusion*. For purposes of applying this section to Participant E for 2006, Participant E could elect to defer $23,000 under Plan Y, which is the maximum deferral limitation under §§ 1.457–4(c)(1) through (3), and to defer no amount under Plans W, X, and Z. The $23,000 maximum amount is equal to the sum of $15,000 plus $8,000, which is the catch-up amount applicable to Participant E under Plan Y and which is the largest catch-up amount applicable to Participant E under any of the four plans for 2006. Alternatively, Participant E could instead elect to defer the following combination of amounts: $5,000 to Plan W and an aggregate total of $15,000 to Plans X, Y, and Z; $22,000 to Plan W and none to any of the other three plans; $17,000 to Plan X and none to any of the other three plans; or $15,000 to Plan Z and none to any of the other three plans.

(iii) If the underutilized amount under Plans W, X, and Y for 2006 were in each case zero (because E had always contributed the maximum amount or E was a new participant) or an amount not in excess of $5,000, the maximum exclusion under this section would be $20,000 for Participant E for 2006 ($15,000 plus the $5,000 age 50 catch-up amount), which Participant E could contribute to Plan W.

§ 1.457–6 Timing of distributions under eligible plans.

(a) *In general.* Except as provided in paragraph (c) of this section (relating to distributions on account of an unforeseeable emergency), paragraph (e) of this section (relating to distributions of small accounts), § 1.457–10(a) (relating to plan terminations), or § 1.457–10(c) (relating to domestic relations orders), amounts deferred under an eligible governmental plan may not be paid to a participant or beneficiary before the participant has a severance from employment with the eligible employer. For rules relating to loans, see paragraph (f) of this section.

(b) *Severance from employment*—(1) *Employees.* An employee has a severance from employment with the eligible employer if the employee dies, retires, or otherwise has a severance from employment with the eligible employer.

(2) *Independent contractors*—(i) *In general.* An independent contractor is considered to have a severance from employment with the eligible employer upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the eligible employer, if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and complete termination of the contractual relationship if the eligible employer anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, an eligible employer is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to again contract for the services provided under the expired contract, and neither the eligible employer nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, an eligible employer is considered to intend to again contract for the services provided under an expired contract if the eligible employer's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

(ii) *Special rule.* Notwithstanding paragraph (b)(2)(i) of this section, the plan is considered to satisfy the requirement described in paragraph (a) of this section that no amounts deferred under the plan be paid or made available to the participant before the participant has a severance from employment with the eligible employer, if, with respect to amounts payable to a participant who is an independent contractor, an eligible plan provides that—

(A) No amount will be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the eligible employer (or, in the case of more than one contract, all such contracts expire); and

(B) No amount payable to the participant on that date will be paid to the participant if, after the expiration of the contract (or contracts) and before that date, the participant performs services for the eligible employer as an independent contractor or an employee.

(c) *Rules applicable to distributions for unforeseeable emergencies*—(1) *In general.* An eligible plan may permit a distribution to a participant or beneficiary faced with an unforeseeable emergency. The distribution must satisfy the requirement of paragraph (c)(2) of this section.

(2) *Requirements*—(i) *Unforeseeable emergency defined.* An unforeseeable emergency must be defined in the plan as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse or the participant's or beneficiary's dependent (as defined in section 152(a)); loss of the participant's or beneficiary's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. For example, the imminent foreclosure of or eviction from the participant's or beneficiary's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including nonrefundable deductibles, as well as for the cost of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a family member may also constitute an unforeseeable emergency. Except in extraordinary circumstances, the purchase of a home and the payment of college tuition are not unforeseeable emergencies under this paragraph (c)(2).

(ii) *Unforeseeable emergency distribution standard.* Whether a participant or beneficiary is faced with an unforeseeable emergency permitting a distribution under this paragraph (c) is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise; by liquidation of the participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship; or by cessation of deferrals under the plan.

(iii) *Distribution necessary to satisfy emergency need.* Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution).

(d) Minimum required distributions for eligible plans. In order to be an eligible plan, a plan must meet the distribution requirements of section 457(d)(1) and (2). Under section 457(d)(2), a plan must meet the minimum distribution requirements of section 401(a)(9). See section 401(a)(9) and the regulations thereunder for these requirements. Section 401(a)(9) requires that a plan begin lifetime distributions to a participant no later than April 1 of the calendar year following the later of the calendar year in which the participant attains age 70 ½ or the calendar year in which the participant retires.

(e) *Distributions of smaller accounts*—(1) *In general.* An eligible plan may provide for a distribution of all or a portion of a dollar amount which is not attributable to rollover contributions (as defined in section 411(a)(11)(D)). In order to permit such a distribution, an eligible plan must provide that the amount of the distribution must not exceed the dollar limit under section 411(a)(11)(A) (which is $5,000 for 2002) and that the distribution is made only if no amount has been deferred under the plan by or for the participant during the two-year period ending on the date of the distribution and

there has been no prior distribution under the plan to the participant under this paragraph (e). An eligible plan is not required to permit distributions under this paragraph (e).

(2) *Alternative provisions possible.* Consistent with the provisions of paragraph (e)(1) of this section, a plan may provide that the total amount deferred for a participant or beneficiary, if not in excess of the applicable dollar limit of section 411(a)(11)(A), will be distributed automatically to the participant or beneficiary if the requirements of paragraph (e)(1) of this section are met. Alternatively, the plan may provide for the total amount deferred for a participant or beneficiary, if not in excess of the applicable dollar limit of section 411(a)(11)(A), to be distributed to the participant or beneficiary only if the participant or beneficiary so elects. The plan is permitted to substitute a specified dollar amount that is less than the applicable dollar limit of section 411(a)(11)(A) under either of these alternatives. In addition, these two alternatives can be combined; for example, a plan could provide for automatic distributions for account balances totaling an amount not in excess of the applicable dollar limit of section 411(a)(11)(A) but allow participants or beneficiary to elect a distribution if the total account balance is above $500 but not above the applicable dollar limit of section 411(a)(11)(A).

(f) *Loans from eligible plans*—(1) *Eligible plans of tax-exempt entities.* If a participant or beneficiary receives (directly or indirectly) any amount deferred as a loan from an eligible plan of a tax-exempt entity, that amount will be treated as having been paid or made available to the individual as a distribution under the plan, in violation of the distribution requirements of section 457(d).

(2) *Eligible governmental plans.* The determination of whether the availability of a loan, the making of a loan, or a failure to repay a loan made from a trustee (or a person treated as a trustee under section 457(g)) of an eligible governmental plan to a participant or beneficiary is treated as a distribution (directly or indirectly) for purposes of this section, and the determination of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in any other respect a violation of the requirements of section 457(b) and the regulations, depends on the facts and circumstances. Thus, for example, a loan must bear a reasonable rate of interest in order to satisfy the exclusive benefit requirement of section 457(g)(1) and § 1.457–8(a)(1). See also § 1.457–7(b)(3) relating to the application of section 72(p) with respect to the taxation of a loan made under an eligible governmental plan, and § 1.72(p)–1 relating to section 72(p)(2).

(3) *Example.* The provisions of paragraph (f)(2) of this section are illustrated by the following example:

Example. (i) *Facts.* Eligible Plan X of State Y is funded through Trust Z. Plan X provides for an employee's account balance under Plan X to be paid in 5 annual installments (of 1/5th the account balance the first year, 1/4th the account balance the second year, etc.) beginning at severance from employment with State Y. Plan X includes a loan program under which any active employee with a vested account balance may receive a loan from Trust Z. Loans are made pursuant to plan provisions regarding loans that are set forth in the plan under which loans bear a reasonable rate of interest and are secured by the employee's account balance. In order to avoid taxation under § 1.457–7(b)(3) and section 72(p)(1), the plan provisions limit the amount of loans and require loans to be repaid in level installments as required under section 72(p)(2). Participant J's vested account balance under Plan X is $50,000. J receives a loan from Trust Z in the amount of $5,000 on December 1, 2003 to be repaid in level installments made quarterly over the 5-year period ending on November 30, 2008. Participant J makes the required repayments until J has a severance from employment from State Y in 2005 and subsequently fails to repay the outstanding loan balance of $2,250. The $2,250 loan balance is offset against J's $80,000 account balance benefit under Plan X, and J is paid one fifth of the remaining $77,750 in 2005.

(ii) *Conclusion.* The making of the loan to J will not be treated as a violation of the requirements of section 457(b) or the regulations. The cancellation of the loan at severance from employment does not cause Plan X to fail to satisfy the requirements for plan eligibility under section 457. In addition, because the loan satisfies the maximum amount and repayment requirements of section 72(p)(2), J is not required to include any amount in income as a result of the loan until 2005, when J has income of $2,250 as a result of the offset (which is a permissible distribution under this section) and income of $15,550 (one fifth of $77,750) as a result of the first annual installment payment.

§ 1.457–7 Taxation of distributions under eligible plans.

(a) *General rules for when amounts are included in gross income.* The rules for determining when an amount deferred under an eligible plan is includible in the gross income of a participant or beneficiary depend on whether the plan is an eligible governmental plan or an eligible plan of a tax-exempt entity. Paragraph (b) of this section sets forth the rules for an eligible governmental plan. Paragraph (c) of this section sets forth the rules for an eligible plan of a tax-exempt entity.

(b) *Amounts included in gross income under an eligible governmental plan*—(1) *Amounts included in gross income in year paid under an eligible governmental plan.* Except as provided in paragraphs (b)(2) and (3) of this section (or in § 1.457–10(c) relating to payments to a spouse or former spouse pursuant to a qualified domestic relations order), amounts deferred under an eligible governmental plan are includible in the gross income of a participant or beneficiary for the taxable year in which paid to the participant or beneficiary under the plan.

(2) *Rollovers to individual retirement arrangements and other eligible retirement plans.* A trustee-to-trustee transfer in accordance with section 401(a)(31) (generally referred to as a direct rollover) is not includible in gross income of a participant or beneficiary in the year transferred. In addition, any payment made in the form of an eligible rollover distribution (as defined in section 402(c)(4)) is not includible in gross income in the year paid to the extent the payment is transferred to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the transfer to the eligible retirement plan of any property distributed from the eligible governmental plan. For this purpose, the rules of section 402(c)(2) through (7) and (9) apply. Any trustee-to-trustee transfer under this paragraph (b)(2) is a distribution that is subject to the distribution requirements of § 1.457–6.

(3) *Amounts taxable under section 72(p)(1).* In accordance with section 72(p), the amount of any loan from an eligible governmental plan to a participant or beneficiary (including any pledge

or assignment treated as a loan under section 72(p)(1)(B)) is treated as having been received as a distribution from the plan under section 72(p)(1), except to the extent set forth in section 72(p)(2) (relating to loans that do not exceed a maximum amount and that are repayable in accordance with certain terms) and § 1.72(p)–1. Thus, except to the extent a loan satisfies section 72(p)(2), any amount loaned from an eligible governmental plan to a participant or beneficiary (including any pledge or assignment treated as a loan under section 72(p)(1)(B)) is includible in the gross income of the participant or beneficiary for the taxable year in which the loan is made. See generally § 1.72(p)–1.

(4) *Examples*. The provisions of this paragraph (b) are illustrated by the following examples:

Example 1. (i) *Facts*. Eligible Plan G of a governmental entity permits distribution of benefits in a single sum or in installments of up to 20 years, with such benefits to commence at any date that is after severance from employment (but not later than the plan's normal retirement age of 65). Effective for participants who have a severance from employment after December 31, 2001, Plan X allows an election—as to both the date on which payments are to begin and the form in which payments are to be made—to be made by the participant at any time that is before the commencement date selected. However, Plan X chooses to require elections to be filed at least 30 days before the commencement date selected in order for Plan X to have enough time to be able to effectuate the election.

(ii) *Conclusion*. No amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

Example 2. (i) *Facts*. Same facts as in *Example 1*, except that the same rules are extended to participants who had a severance from employment before January 1, 2002.

(ii) *Conclusion*. For all participants (*i.e.*, both those who have a severance from employment after December 31, 2001, and those who have a severance from employment before January 1, 2002 (including those whose benefit payments have commenced before January 1, 2002)), no amounts are included in gross income before actual payments begin. If installment payments begin (and the installment payments are payable over at least 10 years so as not to be eligible rollover distributions), the amount included in gross income for any year is equal to the amount of the installment payment paid during the year.

(c) *Amounts included in gross income under an eligible plan of a tax-exempt entity*—(1) *Amounts included in gross income in year paid or made available under an eligible plan of a tax-exempt entity*. Amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of a participant or beneficiary for the taxable year in which paid or otherwise made available to the participant or beneficiary under the plan. Thus, amounts deferred under an eligible plan of a tax-exempt entity are includible in the gross income of the participant or beneficiary in the year the amounts are first made available under the terms of the plan, even if the plan has not distributed the amounts deferred. Amounts deferred under an eligible plan of a tax-exempt entity are not considered made available to the participant or beneficiary solely because the participant or beneficiary is permitted to choose among various investments under the plan.

(2) *When amounts deferred are considered to be made available under an eligible plan of a tax-exempt entity*—(i) *General rule*. Except as provided in paragraphs (c)(2)(ii) through (iv) of this section, amounts deferred under an eligible plan of a tax-exempt entity are considered made available (and, thus, are includible in the gross income of the participant or beneficiary under this paragraph (c)) at the earliest date, on or after severance from employment, on which the plan allows distributions to commence, but in no event later than the date on which distributions must commence pursuant to section 401(a)(9). For example, in the case of a plan that permits distribution to commence on the date that is 60 days after the close of the plan year in which the participant has a severance from employment with the eligible employer, amounts deferred are considered to be made available on that date. However, distributions deferred in accordance with paragraphs (c)(2)(ii) through (iv) of this section are not considered made available prior to the applicable date under paragraphs (c)(2)(ii) through (iv) of this section. In addition, no portion of a participant or beneficiary's account is treated as made available (and thus currently includible in income) under an eligible plan of a tax-exempt entity merely because the participant or beneficiary under the plan may elect to receive a distribution in any of the following circumstances:

(A) If the requirements of § 1.457–4(d) are met, a distribution of amounts representing accumulated sick and vacation pay solely because a participant was entitled to take paid sick or vacation leave in lieu of regular compensation or because the participant could have deferred these amounts under an eligible plan at an earlier date. However, to the extent that the participant is able to receive the value of accumulated sick and vacation pay in cash (in addition to regular compensation) at the time of the election to defer, these amounts are considered made available.

(B) If the requirements of § 1.457–6(c)(2) are met, a distribution in the event of an unforeseeable emergency.

(C) If the requirements of § 1.457–6(e)(1) are met, a distribution not in excess of the dollar limit under section 411(a)(11)(A) (which is $5,000 for 2002) either before or after the participant has a severance from employment with the employer.

(ii) *Initial election to defer commencement of distributions*—(A) *In general*. An eligible plan of a tax-exempt entity may provide a period for making an initial election during which the participant or beneficiary may elect, in accordance with the terms of the plan, to defer the payment of some or all of the amounts deferred to a fixed or determinable future time. The period for making this initial election must expire prior to the first time that any such amounts would be considered made available under the plan under paragraph (c)(2)(i) of this section.

(B) *Failure to make initial election to defer commencement of distributions*. Generally, if no initial election is made by a participant or beneficiary under this paragraph (c)(2)(ii), then the amounts deferred under an eligible plan of a tax-exempt entity are considered made available and taxable to the participant or beneficiary in accordance with paragraph (c)(2)(i) of this section at the earliest time, on or after severance from employment (but in no event later than the date on which distributions must commence pursuant to section 401(a)(9)), that distribution is permitted to commence under the terms of the plan. However, the plan may provide for a default payment schedule that applies if no election is made. If the plan provides for a default payment

schedule, the amounts deferred are includible in the gross income of the participant or beneficiary in the year the amounts deferred are first made available under the terms of the default payment schedule.

(iii) *Additional election to defer commencement of distribution*. An eligible plan of a tax-exempt entity is permitted to provide that a participant or beneficiary who has made an initial election under paragraph (c)(2)(ii)(A) of this section may make one additional election to defer (but not accelerate) commencement of distributions under the plan before distributions have commenced in accordance with the initial deferral election under paragraph (c)(2)(ii)(A) of this section. Amounts payable to a participant or beneficiary under an eligible plan of a tax-exempt entity are not treated as made available merely because the plan allows the participant to make an additional election under this paragraph (c)(2)(iii). A participant or beneficiary is not precluded from making an additional election to defer commencement of distributions merely because the participant or beneficiary has previously received a distribution under § 1.457–6(c) because of an unforeseeable emergency, has received a distribution of smaller amounts under § 1.457–6(e), has made (and revoked) other deferral or method of payment elections within the initial election period, or is subject to a default payment schedule under which the commencement of benefits is deferred (for example, until a participant is age 65).

(iv) *Election as to method of payment*. An eligible plan of a tax-exempt entity may provide that the election as to the method of payment under the plan may be made at any time prior to the time the amounts are distributed in accordance with the participant or beneficiary's initial or additional election to defer commencement of distributions under paragraph (c)(2)(ii) or (iii) of this section. Where no method of payment is elected, the entire amount deferred will be includible in the gross income of the participant or beneficiary when the amounts first become made available in accordance with a participant's initial or additional elections to defer under paragraphs (c)(2)(ii) and (iii) of this section, unless the eligible plan provides for a default method of payment (in which case amounts are considered made available and taxable when paid under the terms of the default payment schedule).

(3) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) *Facts*. Eligible Plan X of a tax-exempt entity provides that a participant's total account balance, representing all amounts deferred under the plan, is payable to a participant in a single sum 60 days after severance from employment throughout these examples, unless, during a 30-day period immediately following the severance, the participant elects to receive the single sum payment at a later date (that is not later than the plan's normal retirement age of 65) or elects to receive distribution in 10 annual installments to begin 60 days after severance from employment (or at a later date, if so elected, that is not later than the plan's normal retirement age of 65). On November 13, 2002, participant K, a calendar year taxpayer, has a severance from employment with the eligible employer. K does not, within the 30-day window period, elect to postpone distributions to a later date or to receive payment in 10 fixed annual installments.

(ii) *Conclusion*. The single sum payment is payable to K 60 days after the date K has a severance from employment (January 12, 2003), and is includible in the gross income of K in 2003 under section 457(a).

Example 2. (i) *Facts*. The terms of eligible Plan X are the same as described in *Example 1*. Participant L participates in eligible Plan X. On November 11, 2002, participant L has a severance from the employment of the eligible employer. On November 24, 2002, L makes an initial deferral election not to receive the single sum payment payable 60 days after the severance, and instead elects to receive the amounts in 10 annual installments to begin 60 days after severance from employment.

(ii) *Conclusion*. No portion of L's account is considered made available in 2002 or 2003 before a payment is made and no amount is includible in the gross income of L until distributions commence. The annual installment payable in 2003 will be includible in L's gross income in 2003.

Example 3. (i) *Facts*. The facts are the same as in *Example 1*, except that eligible Plan X also provides that those participants who are receiving distributions in 10 annual installments may, at any time and without restriction, elect to receive a cash out of all remaining installments. Participant M elects to receive a distribution in 10 annual installments commencing in 2003.

(ii) *Conclusion*. M's total account balance, representing the total of the amounts deferred under the plan, is considered made available in, and is includible in M's gross income, in 2003.

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that, instead of providing for an unrestricted cash out of remaining payments, the plan provides that participants or beneficiaries who are receiving distributions in 10 annual installments may accelerate the payment of the amount remaining payable to the participant upon the occurrence of an unforeseeable emergency as described in § 1.457–6(c)(1) in an amount not exceeding that described in § 1.457–6(c)(2).

(ii) *Conclusion*. No amount is considered made available to participant M on account of M's right to accelerate payments upon the occurrence of an unforeseeable emergency.

Example 5. (i) *Facts*. Eligible Plan Y of a tax-exempt entity provides that distributions will commence 60 days after a participant's severance from employment unless the participant elects, within a 30-day window period following severance from employment, to defer distributions to a later date (but no later than the year following the calendar year the participant attains age 70 ½). The plan provides that a participant who has elected to defer distributions to a later date may make an election as to form of distribution at any time prior to the 30th day before distributions are to commence.

(ii) *Conclusion*. No amount is considered made available prior to the date distributions are to commence by reason of a participant's right to defer or make an election as to the form of distribution.

Example 6. (i) *Facts*. The facts are the same as in *Example 1*, except that the plan also permits participants who have earlier made an election to defer distribution to make one additional deferral election at any time prior to the date distributions are scheduled to commence. Participant N has a severance from employment at age 50. The next day, during the 30-day period provided in the plan, N elects to receive distribution in the form of 10 annual installment payments beginning at age 55. Two weeks later, within the 30-day window period, N makes a new election permitted under the plan to receive 10 annual installment payments beginning at age 60 (instead of age 55). When N is age 59, N elects under the additional deferral election provisions, to defer distributions until age 65.

(ii) *Conclusion*. In this example, N's election to defer distributions until age 65 is a valid election. The two elections N makes during the 30-day window period are not additional deferral elections described in paragraph (c)(2)(iii) of this section because they are made before the first permissible payout date under the plan. Therefore, the plan is not precluded from allowing N to make the additional deferral election. However, N can make no further election to defer distributions beyond age 65 because this additional deferral election can only be made once.

§ 1.457–8 Funding rules for eligible plans.

(a) *Eligible governmental plans*—(1) *In general*. In order to be an eligible governmental plan, all amounts deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights, must be held in trust for the exclusive benefit of participants and their beneficiaries. A trust described in this paragraph (a) that also meets the requirements of §§ 1.457–3 through 1.457–10 is treated as an organization exempt from tax under section 501(a), and a participant's or beneficiary's interest in amounts in the trust is includible in

the gross income of the participants and beneficiaries only to the extent, and at the time, provided for in section 457(a) and §§ 1.457–4 through 1.457–10.

(2) *Trust requirement.* (i) A trust described in this paragraph (a) must be established pursuant to a written agreement that constitutes a valid trust under state law. The terms of the trust must make it impossible, prior to the satisfaction of all liabilities with respect to participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than for the exclusive benefit of participants and their beneficiaries.

(ii) Amounts deferred under an eligible governmental plan must be transferred to a trust within a period that is not longer than is reasonable for the proper administration of the participant accounts (if any). For purposes of this requirement, the plan may provide for amounts deferred for a participant under the plan to be transferred to the trust within a specified period after the date the amounts would otherwise have been paid to the participant. For example, the plan could provide for amounts deferred under the plan to be contributed to the trust within 15 business days following the month in which these amounts would otherwise have been paid to the participant.

(3) *Custodial accounts and annuity contracts treated as trusts*—(i) *In general.* For purposes of the trust requirement of this paragraph (a), custodial accounts and annuity contracts described in section 401(f) that satisfy the requirements of this paragraph (a)(3) are treated as trusts under rules similar to the rules of section 401(f). Therefore, the provisions of § 1.401(f)–1(b) will generally apply to determine whether a custodial account or an annuity contract is treated as a trust. The use of a custodial account or annuity contract as part of an eligible governmental plan does not preclude the use of a trust or another custodial account or annuity contract as part of the same plan, provided that all such vehicles satisfy the requirements of section 457(g)(1) and (3) and paragraphs (a)(1) and (2) of this section and that all assets and income of the plan are held in such vehicles.

(ii) *Custodial accounts*—(A) *In general.* A custodial account is treated as a trust, for purposes of section 457(g)(1) and paragraph (a)(1) and (2) of this section, if the custodian is a bank, as described in section 408(n), or a person who meets the nonbank trustee requirements of paragraph (a)(3)(ii)(B) of this section, and the account meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust.

(B) *Nonbank trustee status.* The custodian of a custodial account may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer the custodial account will be consistent with the requirements of section 457(g)(1) and (3). To do so, the person must demonstrate that the requirements of § 1.408–2(e)(2) through (6) (relating to nonbank trustees) are met. The written application must be sent to the address prescribed by the Commissioner in the same manner as prescribed under § 1.408–2(e). To the extent that a person has already demonstrated to the satisfaction of the Commissioner that the person satisfies the requirements of § 1.408–2(e) in connection with a qualified trust (or custodial account or annuity contract) under section 401(a), that person is deemed to satisfy the requirements of this paragraph (a)(3)(ii)(B).

(iii) *Annuity contracts.* An annuity contract is treated as a trust for purposes of section 457(g)(1) and paragraph (a)(1) of this section if the contract is an annuity contract, as defined in section 401(g), that has been issued by an insurance company qualified to do business in the State, and the contract meets the requirements of paragraphs (a)(1) and (2) of this section, other than the requirement that it be a trust. An annuity contract does not include a life, health or accident, property, casualty, or liability insurance contract.

(4) *Combining assets.* [Reserved]

(b) *Eligible plans maintained by tax-exempt entity*—(1) *General rule.* In order to be an eligible plan of a tax-exempt entity, the plan must be unfunded and plan assets must not be set aside for participants or their beneficiaries. Under section 457(b)(6) and this paragraph (b), an eligible plan of a tax-exempt entity must provide that all amounts deferred under the plan, all property and rights to property (including rights as a beneficiary of a contract providing life insurance protection) purchased with such amounts, and all income attributable to such amounts, property, or rights, must remain (until paid or made available to the participant or beneficiary) solely the property and rights of the eligible employer (without being restricted to the provision of benefits under the plan), subject only to the claims of the eligible employer's general creditors.

(2) *Additional requirements.* For purposes of paragraph (b)(1) of this section, the plan must be unfunded regardless of whether or not the amounts were deferred pursuant to a salary reduction agreement between the eligible employer and the participant. Any funding arrangement under an eligible plan of a tax-exempt entity that sets aside assets for the exclusive benefit of participants violates this requirement, and amounts deferred are generally immediately includible in the gross income of plan participants and beneficiaries. Nothing in this paragraph (b) prohibits an eligible plan from permitting participants and their beneficiaries to make an election among different investment options available under the plan, such as an election affecting the investment of the amounts described in paragraph (b)(1) of this section.

§ 1.457–9 Effect on eligible governmental plan when not administered in accordance with eligibility requirements.

A plan of a state ceases to be an eligible governmental plan on the first day of the first plan year beginning more than 180 days after the date on which the Commissioner notifies the state in writing that the plan is being administered in a manner that is inconsistent with one or more of the requirements of §§ 1.457–3 through 1.457–8, or 1.457–10. However, the plan may correct the plan inconsistencies specified in the written notification before the first day of that plan year and continue to maintain plan eligibility. If a plan ceases to be an eligible governmental plan, amounts subsequently deferred by participants will be includible in income when deferred, or, if later, when the amounts deferred cease to be subject to a substantial risk of forfeiture, as provided at § 1.457–11. Amounts deferred before the date on which the plan ceases to be an eligible governmental plan, and

any earnings thereon, will be treated as if the plan continues to be an eligible governmental plan and will not be includible in participant's or beneficiary's gross income until paid to the participant or beneficiary.

§ 1.457–10 Miscellaneous provisions.

(a) *Plan terminations and frozen plans*—(1) *In general.* An eligible employer may amend its plan to eliminate future deferrals for existing participants or to limit participation to existing participants and employees. An eligible plan may also contain provisions that permit plan termination and permit amounts deferred to be distributed on termination. In order for a plan to be considered terminated, amounts deferred under an eligible plan must be distributed to all plan participants and beneficiaries as soon as administratively practicable after termination of the eligible plan. The mere provision for, and making of, distributions to participants or beneficiaries upon a plan termination will not cause an eligible plan to cease to satisfy the requirements of section 457(b) or the regulations.

(2) *Employers that cease to be eligible employers*—(i) *Plan not terminated.* An eligible employer that ceases to be an eligible employer may no longer maintain an eligible plan. If the employer was a tax-exempt entity and the plan is not terminated as permitted under paragraph (a)(2)(ii) of this section, the tax consequences to participants and beneficiaries in the previously eligible (unfunded) plan of an ineligible employer will be determined in accordance with either section 451 if the employer becomes an entity other than a state or §1.457–11 if the employer becomes a state. If the employer was a state and the plan is neither terminated as permitted under paragraph (a)(2)(ii) of this section nor transferred to another eligible plan of that state as permitted under paragraph (b) of this section, the tax consequences to participants in the previously eligible governmental plan of an ineligible employer, the assets of which are held in trust pursuant to § 1.457–8(a), will be determined in accordance with section 402(b) (section 403(c) in the case of an annuity contract) and the trust will no longer be treated as a trust that is exempt from tax under section 501(a).

(ii) *Plan termination.* As an alternative to determining the tax consequences to the plan and participants under paragraph (a)(2)(i) of this section, the employer may terminate the plan and distribute the amounts deferred (and all plan assets) to all plan participants as soon as administratively practicable in accordance with paragraph (a)(1) of this section. Such distribution may include eligible rollover distributions in the case of a plan that was an eligible governmental plan. In addition, if the employer is a state, another alternative to determining the tax consequences under paragraph (a)(2)(i) of this section is to transfer the assets of the eligible governmental plan to an eligible governmental plan of another eligible employer within the same state under the plan-to-plan transfer rules of paragraph (b) of this section.

(3) *Examples.* The provisions of this paragraph (a) are illustrated by the following examples:

Example 1. (i) *Facts.* Employer Y, a corporation that owns a state hospital, sponsors an eligible governmental plan funded through a trust. Employer Y is acquired by a for-profit hospital and Employer Y ceases to be an eligible employer under section 457(e)(1) or § 1.457–2(e). Employer Y terminates the plan and, during the next 6 months, distributes to participants and beneficiaries all amounts deferred that were under the plan.

(ii) *Conclusion.* The termination and distribution does not cause the plan to fail to be an eligible governmental plan. Amounts that are distributed as eligible rollover distributions may be rolled over to an eligible retirement plan described in section 402(c)(8)(B).

Example 2. (i) *Facts.* The facts are the same as in *Example 1*, except that Employer Y decides to continue to maintain the plan.

(ii) *Conclusion.* If Employer Y continues to maintains the plan, the tax consequences to participants and beneficiaries with respect to compensation deferred thereafter will be determined in accordance with either section 402(b) if the compensation deferred is funded through a trust, section 403(c) if the compensation deferred is funded through annuity contracts, or § 1.457–11 if the compensation deferred is not funded through a trust or annuity contract. In addition, if Employer Y continues to maintain the plan, the trust (including amounts deferred before the date on which the plan ceases to be an eligible governmental plan and any earnings thereon) will no longer be treated as exempt from tax under section 501(a).

Example 3. (i) *Facts.* Employer Z, a corporation that owns a tax-exempt hospital, sponsors an unfunded eligible plan. Employer Z is acquired by a for-profit hospital and is no longer an eligible employer under section 457(e)(1) or § 1.457–2(e). Employer Z terminates the plan and distributes all amounts deferred under the eligible plan to participants and beneficiaries within a one-year period.

(ii) *Conclusion.* Distributions under the plan are treated as made under an eligible plan of a tax-exempt entity and the distributions of the amounts deferred are includible in the gross income of the participant or beneficiary in the year distributed.

Example 4. (i) *Facts.* The facts are the same as in *Example 3*, except that Employer Z decides to maintain instead of terminate the plan.

(ii) *Conclusion.* If Employer Z maintains the plan, the tax consequences to participants and beneficiaries in the plan will thereafter be determined in accordance with section 451.

(b) *Plan-to-plan transfers*—(1) *General rule.* An eligible governmental plan may provide for the transfer of amounts deferred by a participant or beneficiary to another eligible governmental plan, and an eligible plan of a tax-exempt entity may provide for transfers of amounts deferred by a participant to another eligible plan of a tax-exempt entity, if the conditions in paragraph (b)(2) of this section are met. An eligible governmental plan may accept transfers from another eligible governmental plan as described in the preceding sentence, and an eligible plan of a tax-exempt entity may accept transfers from another eligible plan of a tax-exempt entity as described in the preceding sentence. However, a state may not transfer the assets of its eligible governmental plan to a tax-exempt entity's eligible plan and the plan of a tax-exempt entity may not accept such a transfer. Similarly, a tax-exempt entity may not transfer the assets of its eligible plan to an eligible governmental plan and an eligible governmental plan may not accept such a transfer. In addition, if the conditions in paragraph (b)(4) of this section (relating to permissive past service credit and repayments under section 415) are met, an eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a qualified plan (under section 401(a)) maintained by a state. However, a qualified plan may not transfer assets to an eligible governmental plan or to an eligible plan of a tax-exempt entity, and an eligible governmental plan or the plan of a tax-exempt entity may not accept such a transfer.

(2) *Requirements for plan-to-plan transfers among eligible plans.* A transfer under paragraph (b)(1) of this section from an eligible governmental plan to another eligible governmental plan is permitted only if the following conditions are met —

(i) The transferor plan provides for transfers;

(ii) The receiving plan provides for the receipt of transfers;

(iii) The participant or beneficiary whose amounts deferred are being transferred will have an amount deferred immediately after the transfer at least equal to the amount deferred with respect to that participant or beneficiary immediately before the transfer; and

(iv) The participant or beneficiary whose amounts deferred are being transferred has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan. However, this paragraph (b)(2)(iv) is not required to be satisfied if—

(A) All of the assets held by the eligible governmental plan are transferred;

(B) The transfer is to another eligible governmental plan maintained by an eligible employer that is a state entity within the same state; and

(C) The participants whose deferred amounts are being transferred are not eligible for additional annual deferrals in the receiving plan unless they are performing services for the entity maintaining the receiving plan.

(3) *Examples*. The provisions of paragraphs (b)(1) and (2) of this section are illustrated by the following examples:

Example 1. (i) *Facts*. Participant A, the president of City X's hospital, has accepted a position with another hospital which is a tax-exempt entity. A participates in the eligible governmental plan of City X. A would like to transfer the amounts deferred under City X's eligible governmental plan to the eligible plan of the tax-exempt hospital.

(ii) *Conclusion*. City X's plan may not transfer A's amounts deferred to the tax-exempt employer's eligible plan. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and § 1.457–8(a).

Example 2. (i) *Facts*. County M, located in State S, operates several health clinics and maintains an eligible governmental plan for employees of those clinics. One of the clinics operated by County M is being acquired by a hospital operated by State S, and employees of that clinic will become employees of State S. County M permits those employees to transfer their balances under County M's eligible governmental plan to the eligible governmental plan of State S.

(ii) *Conclusion*. If the eligible governmental plans of County M and State S provide for the transfer and acceptance of the transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), the transfer will not cause either plan to violate the requirements of section 457 or these regulations.

Example 3. (i) *Facts*. City Employer Z, a hospital, sponsors an eligible governmental plan. City Employer Z is located in State B. All of the assets of City Employer Z are being acquired by a tax-exempt hospital. City Employer Z, in accordance with the plan-to-plan transfer rules of paragraph (b) of this section, would like to transfer the total amount of assets deferred under City Employer Z's eligible governmental plan to the acquiring tax-exempt entity's eligible plan.

(ii) *Conclusion*. City Employer Z may not permit participants to transfer the amounts to the eligible plan of the tax-exempt entity. In addition, because the amounts deferred would no longer be held in trust for the exclusive benefit of participants and their beneficiaries, the transfer would violate the exclusive benefit rule of section 457(g) and § 1.457–8(a).

Example 4. (i) *Facts*. The facts are the same as in *Example 3*, except that City Employer Z, prior to the transfer of all of its assets to the eligible plan of the tax-exempt entity, decides to transfer all of the amounts deferred under City Z's eligible governmental plan to the eligible governmental plan of the related state government entity, State B.

(ii) *Conclusion*. If City Employer Z's (transferor) eligible governmental plan provides for such transfer and the eligible governmental plan of the State B permits the acceptance of such a transfer (and the other requirements of paragraph (b)(1) of this section are satisfied), City Employer Z may transfer the total amounts deferred under its eligible governmental plan, prior to termination of that plan, to the eligible governmental plan maintained by State B. However, the participants of City Employer Z whose deferred amounts are being transferred are not eligible to participate in the eligible governmental plan of State B, the receiving plan, unless they are performing services for State B.

(4) *Purchase of permissive past service credit by plan-to-plan transfers from an eligible governmental plan to a qualified plan*—(i) *General rule*. An eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a defined benefit governmental plan (as defined in section 414(d)) of that state, and no amount shall be includible in gross income by reason of the transfer, if the conditions in paragraph (b)(4)(ii) of this section are met. A transfer under this paragraph (b)(4) is not treated as a distribution for purposes of § 1.457–6. Therefore, such a transfer may be made before severance from employment.

(ii) *Conditions for plan-to-plan transfers from an eligible governmental plan to a qualified plan*. A transfer may be made under this paragraph (b)(4) only if the transfer is either—

(A) For the purchase of permissive past service credit (as defined in section 415(n)(3)(A)) under the receiving defined benefit governmental plan; or

(B) A repayment to which section 415 does not apply by reason of section 415(k)(3).

(iii) *Example*. The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) *Facts*. Plan X is an eligible governmental plan maintained by County Y for its employees. Plan X provides for distributions only in the event of death, an unforeseeable emergency, or severance from employment with Y (including retirement from Y). Plan S is a qualified defined benefit plan maintained by State T for its employees. County Y is within State T. Employee A is an employee of Y and is a participant in Plan X. Employee A previously was an employee of T and is still entitled to benefits under Plan S. Plan S includes provisions allowing participants in certain plans, including Plan X, to transfer assets to Plan S for the purchase past service credit under Plan S not in excess of the credit permitted under section 415(n) and does not permit the amount transferred to exceed the amount necessary to fund the benefit resulting from the past service credit. Although not required to do so, Plan X allows A to transfer assets to Plan T to provide a past service benefit under Plan T.

(ii) *Conclusion*. Assuming that the special rules at section 415(n)(3) are satisfied with respect to the transfer, the transfer is permitted under this paragraph (b)(4).

(c) *Qualified domestic relations orders under eligible plans*—(1) *General rule*. An eligible plan does not become an ineligible plan described in section 457(f) solely because its administrator or sponsor complies with a qualified domestic relations order as defined in section 414(p), including an order requiring the distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions under § 1.457–6. If a distribution or payment is made from an eligible plan to an alternate payee pursuant to a qualified domestic relations order, rules similar to the rules of section 402(e)(1)(A) shall apply to the distribution or payment.

(2) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

Example 1. (i) *Facts*. Participant C and C's spouse D are divorcing. C is employed by State S and is a participant in an eligible plan maintained by S. C has an account valued at $100,000 under the plan. Pursuant to the divorce, a court issues a qualified domestic relations order on September 1, 2003, that allocates 50 percent of C's $100,000 plan

account to D and specifically provides for an immediate distribution to D of D's share within 6 months of the order. Payment is made to D in January of 2004.

(ii) *Conclusion*. S's eligible plan does not become an ineligible plan described in section 457(f) and § 1.457–11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under § 1.457–6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share will be includible in D's gross income when paid to D.

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that S is a tax-exempt entity, instead of a state.

(ii) *Conclusion*. S's eligible plan does not become an ineligible plan described in section 457(f) and § 1.457–11 solely because its administrator or sponsor complies with the qualified domestic relations order requiring the immediate distribution to D in advance of the general rules for eligible plan distributions under § 1.457–6. In accordance with section 402(e)(1)(A), D (not C) must include the distribution in gross income. The distribution is includible in D's gross income in 2004, assuming that the plan did not make the distribution available to D in 2003. If the qualified domestic relations order were to provide for distribution to D at a future date, amounts deferred attributable to D's share would be includible in D's gross income when paid or made available to D.

(d) *Death benefits and life insurance proceeds*. A death benefit plan under section 457(e)(11) is not an eligible plan. In addition, no amount paid or made available under an eligible plan as death benefits or life insurance proceeds is excludable from gross income under section 101.

(e) *Rollovers to eligible governmental plans*—(1) *General rule*. An eligible governmental plan may accept contributions that are eligible rollover distributions (as defined in section 402(c)(4)) made from another eligible retirement plan (as defined in section 402(c)(8)(B)) if the conditions in paragraph (e)(2) of this section are met. Amounts contributed to an eligible governmental plan as eligible rollover distributions are not taken into account for purposes of the annual limit on annual deferrals by a participant in § 1.457–4(c) or §1.457–5, but are otherwise treated in the same manner as amounts deferred under section 457 for purposes of §§ 1.457–3 through 1.457–9 and this section.

(2) *Conditions for rollovers to an eligible governmental plan*. An eligible governmental plan that permits eligible rollover distributions made from another eligible retirement plan to be paid into the eligible governmental plan is required under this paragraph (e)(2) to provide that it will separately account for any eligible rollover distributions it receives.

(3) *Example*. The provisions of this paragraph (e) are illustrated by the following example:

Example. (i) *Facts*. Plan T is an eligible governmental plan that provides that employees who are eligible to participate in Plan T may make rollover contributions to Plan T from amounts distributed to an employee from an eligible retirement plan. An eligible retirement plan is defined in Plan T as another eligible governmental plan, a qualified section 401(a) or 403(a) plan, or a section 403(b) contract, or an individual retirement arrangement (IRA) that holds such amounts. Plan T requires rollover contributions to be paid by the eligible retirement plan directly to Plan T (a direct rollover) or to be paid by the participant within 60 days after the date on which the participant received the amount from the other eligible retirement plan. Plan T does not take rollover contributions into account for purposes of the plan's limits on amounts deferred that conform to § 1.457–4(c). Rollover contributions paid to Plan T are invested in the trust in the same manner as amounts deferred under Plan T and rollover contributions (and earnings thereon) are available for distribution to the participant at the same time and in the same manner as amounts deferred under Plan T. In addition, Plan T provides that, for each participant who makes a rollover contribution to Plan T, the Plan T recordkeeper is to establish a separate account for the participant's rollover contributions. The recordkeeper calculates earnings and losses for investments held in the rollover account separately from earnings and losses on other amounts held under the plan and calculates disbursements from and payments made to the rollover account separately from disbursements from and payments made to other amounts held under the plan.

(ii) *Conclusion*. Plan T does not lose its status as an eligible governmental plan as a result of the receipt of rollover contributions.

(f) *Deemed IRAs under eligible governmental plans*. [Reserved]

§ 1.457–11 Tax treatment of participants if plan is not an eligible plan.

(a) *In general*. Under section 457(f), if an eligible employer provides for a deferral of compensation under any agreement or arrangement that is an ineligible plan—

(1) Compensation deferred under the agreement or arrangement is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)) of the rights to such compensation;

(2) If the compensation deferred is subject to a substantial risk of forfeiture, the amount includible in gross income for the first taxable year in which there is no substantial risk of forfeiture includes earnings thereon to the date on which there is no substantial risk of forfeiture;

(3) Earnings credited on the compensation deferred under the agreement or arrangement that are not includible in gross income under paragraph (a)(2) of this section are includible in the gross income of the participant or beneficiary only when paid or made available to the participant or beneficiary, provided that the interest of the participant or beneficiary in any assets (including amounts deferred under the plan) of the entity sponsoring the agreement or arrangement is not senior to the entity's general creditors; and

(4) Amounts paid or made available to a participant or beneficiary under the agreement or arrangement are includible in the gross income of the participant or beneficiary under section 72, relating to annuities.

(b) *Exceptions*. Paragraph (a) of this section does not apply with respect to—

(1) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(2) An annuity plan or contract described in section 403;

(3) That portion of any plan which consists of a transfer of property described in section 83;

(4) That portion of any plan which consists of a trust to which section 402(b) applies; or

(5) A qualified governmental excess benefit arrangement described in section 415(m).

(c) *Coordination of section 457(f) with section 83*—(1) *Transfer of property described in section 83*. Under paragraph (b)(3) of this section, section 457(f) and paragraph (a) of this section do not apply to that portion of any plan which consists of a transfer of property described in section 83. For this purpose, a transfer of property described in section 83 means a transfer of property to which section 83 applies. Section 457(f) and paragraph (a) of this section do not apply if the date on

which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan is on or after the date on which there is a transfer of property to which section 83 applies. However, section 457(f) and paragraph (a) of this section apply if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an agreement or arrangement that is not an eligible plan precedes the date on which there is a transfer of property to which section 83 applies. If deferred compensation payable in property is includible in gross income under section 457(f), then, as provided in section 72, the amount includible in gross income when that property is later transferred or made available to the service provider is the excess of the value of the property at that time over the amount previously included in gross income under section 457(f).

(2) *Examples*. The provisions of this paragraph (c) are illustrated in the following examples:

Example 1. (i) *Facts*. As part of an arrangement for the deferral of compensation, an eligible employer agrees on December 1, 2002, to pay an individual rendering services for the eligible employer a specified dollar amount on January 15, 2005. The arrangement provides for the payment to be made in the form of property having a fair market value equal to the specified dollar amount. The individual's rights to the payment are not subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B)).

(ii) *Conclusion*. In this example, because there is no substantial risk of forfeiture with respect to the agreement to transfer property in 2005, the present value (as of December 1, 2002) of the payment is includible in the individual's gross income for 2002. Under paragraph (a)(4) of this section, when the payment is made on January 15, 2005, the amount includible in the individual's gross income is equal to the excess of the fair market value of the property when paid, over the amount that was includible in gross income for 2002 (which is the basis allocable to that payment).

Example 2. (i) *Facts*. As part of an arrangement for the deferral of compensation, individuals A and B rendering services for a tax-exempt entity each receive in 2010 property that is subject to a substantial risk of forfeiture (within the meaning of section 457(f)(3)(B) and within the meaning of section 83(c)(1)). Individual A makes an election to include the fair market value of the property in gross income under section 83(b) and individual B does not make this election. The substantial risk of forfeiture for the property transferred to individual A lapses in 2012 and the substantial risk of forfeiture for the property transferred to individual B also lapses in 2012. Thus, the property transferred to individual A is included in A's gross income for 2010 when A makes a section 83(b) election and the property transferred to individual B is included in B's gross income for 2012 when the substantial risk of forfeiture for the property lapses.

(ii) *Conclusion*. In this example 2, in each case, the compensation deferred is not subject to section 457(f) or this section because section 83 applies to the transfer of property on or before the date on which there is no substantial risk of forfeiture with respect to compensation deferred under the arrangement.

Example 3. (i) *Facts*. In 2010, X, a tax-exempt entity, agrees to pay deferred compensation to employee C. The amount payable is $100,000 to be paid 10 years later in 2020. The commitment to make the $100,000 payment is not subject to a substantial risk of forfeiture. In 2010, the present value of the $100,000 is $50,000. In 2018, X transfers to C property having a fair market value (for purposes of section 83) equal to $70,000. The transfer is in partial settlement of the commitment made in 2010 and, at the time of the transfer in 2018, the present value of the commitment is $80,000. In 2020, X pays C the $12,500 that remains due.

(ii) *Conclusion*. In this example 3, C has income of $50,000 in 2010. In 2018, C has income of $30,000, which is the amount transferred in 2018, minus the allocable portion of the basis that results from the $50,000 of income in 2010. (Under section 72(e)(2)(B), income is allocated first. The income is equal to $30,000 ($80,000 minus the $50,000 basis), with the result that the allocable portion of the basis is equal to $40,000 ($70,000 minus the $30,000 of income).) In 2020, C has income of $2,500 ($12,500 minus $10,000, which is the excess of the original $50,000 basis over the $40,000 basis allocated to the transfer made in 2018).

§ 1.457–12 Effective dates.

Sections 1.457–1 through 1.457–11 apply for taxable years beginning after December 31, 2001, except that § 1.457–11(c) does not apply with respect to an option without a readily ascertainable fair market value (within the meaning of section 83(e)(3)) that was granted on or before May 8, 2002, and, § 1.457–10(c) (relating to qualified domestic relations orders) applies for transfers, distributions, and payments made after December 31, 2001.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 7, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 8, 2002, 67 F.R. 30826)

Hedging Transactions; Corrections

Announcement 2002–55

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains corrections to final regulations (T.D. 8985, 2002–14 I.R.B. 707) that were published in the **Federal Register** on Wednesday, March 20, 2002 (67 FR 12863), relating to the character of gain or loss from hedging transactions.

DATES: This correction is effective March 20, 2002.

FOR FURTHER INFORMATION CONTACT: Elizabeth Handler (202) 622–3930 or Viva Hammer (202) 622–0869 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these corrections are under section 1221 of the Internal Revenue Code.

Need for Correction

As published, the final regulations contain errors that may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, 26 CFR Part 1 is corrected by making the following correcting amendments:

PART 1 — INCOME TAXES

1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 1.446–4 [Corrected]

2. Section 1.446–4, paragraph (d)(3) is amended by removing the language "§ 1.1221–2(a)(4)(i)" from the last sentence and adding the language "§ 1.1221–2(a)(4)" in its place.

§ 1.1256(e)–1 [Corrected]

3. Section 1.1256(e)–1, paragraph (c) is amended by removing the language "(f)(1)(ii)" from the second sentence and adding the language "(g)(1)(ii)" in its place.

New Revision of Publication 597, *Information on the U.S. – Canada Income Tax Treaty*

Announcement 2002–56

Publication 597, revised May 2002, is now available from the Internal Revenue Service. It replaces the May 1998 revision.

This publication discusses a number of the treaty provisions that often apply to U.S. citizens or residents who may be liable for Canadian tax.

You can get a copy of this publication by calling 1–800–TAX-FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. The publication is also available on the IRS web site at *www.irs.gov*.

New Revision of Publication 1544, *Reporting Cash Payments of Over $10,000* (and Publication 1544SP, *Informe de Pagos en Efectivo en Exceso de $10,000*)

Announcement 2002–57

Publication 1544, revised March 2002, is now available from the Internal Revenue Service. It replaces the August 1997 revision. The publication is also available in Spanish as Publication 1544SP.

The publication explains why, when, and how to report large cash payments. It also discusses the substantial penalties for not reporting them.

You can get either version of this publication by calling 1–800–TAX-FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Both versions are also available on the IRS web site at *www.irs.gov*.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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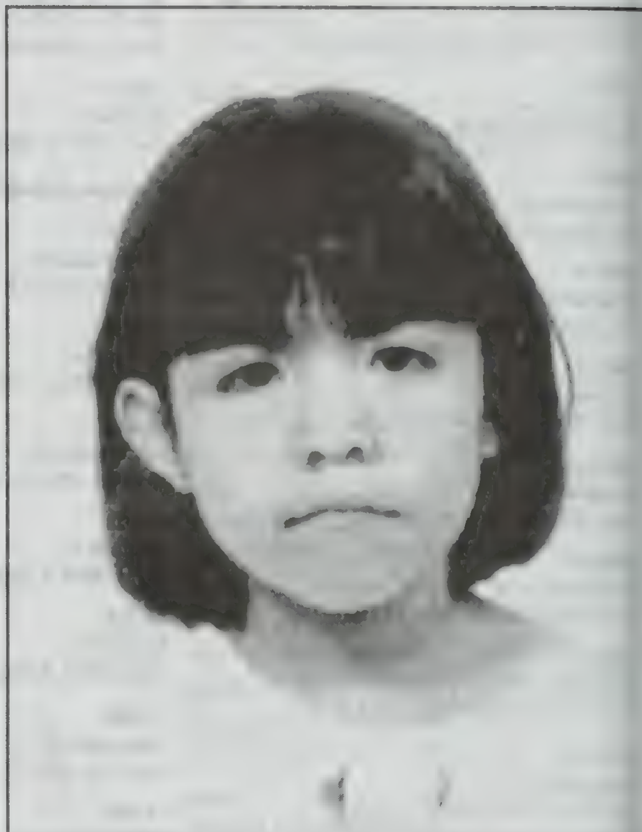

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Bulletin No. 2002–24
June 17, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–36, page 1148.
Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for June 2002.

Rev. Rul. 2002–37, page 1147.
LIFO; price indexes; department stores. The April 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, April 30, 2002.

T.D. 8996, page 1127.
Final regulations under sections 441 and 442 of the Code relate to certain adoptions, changes, and retentions of annual accounting periods. The final regulations primarily affect taxpayers that want to adopt an annual accounting period or that must receive approval from the Commissioner to adopt, change, or retain an annual accounting period. In addition, the regulations provide guidance relating to the taxable years of partnerships and S corporations. Rev. Ruls. 57–589, 65–316, 68–125, 69–563, 74–326, and 78–179 obsolete.

Notice 2002–41, page 1153.
This notice contains guidance for entering into a withholding foreign partnership or withholding foreign trust agreement with the service.

EMPLOYEE PLANS

Rev. Proc. 2002–29, page 1176.
Minimum distributions; regulations; model amendments. This procedure describes the final and temporary regulations under section 401(a)(9) of the Code and provides model amendments for qualified defined contribution plans and for qualified defined benefit plans. Rev. Procs. 2000–20 and 2002–6 modified.

Rev. Proc. 2002–35, page 1187.
Retroactive plan amendments; GUST late amenders. This document establishes streamlined procedures to avoid the disqualification of plans intended to satisfy sections 401(a) or 403(a) of the Code on account of the plans' failure to be timely amended for GUST. Rev. Proc. 2001–17 modified.

EXCISE TAX

Rev. Rul. 2002–34, page 1150.
Segment Tax. This ruling provides guidance on how to calculate the tax under section 4261(b) of the Code on domestic segments if an aircraft is chartered and one or more persons are transported on that aircraft.

ADMINISTRATIVE

Notice 2002–40, page 1152.
This notice supplements the relief granted in Notice 2001–61, 2001–40 I.R.B. 305, and Notice 2001–68, 2001–47 I.R.B. 504, for taxpayers affected by the September 11, 2001, terrorist attack by expanding relief from interest and penalties. The notice implements changes that were made to section 7508A of the Code by the Victims of Terrorism Tax Relief Act of 2001.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Rev. Proc. 2002–30, page 1184.
This procedure provides for a pilot program that will test whether the process for issuing Technical Advice Memoranda (TAM) can be streamlined. The new advice will be known as a Technical Expedited Advice Memorandum (TEAM). Rev. Proc. 2002–2 modified.

Rev. Proc. 2002–42, page 1188.
This procedure sets forth a process whereby taxpayers who purchase motor vehicles propelled by both a gasoline internal combustion engine and an electric motor that is recharged as the motor vehicles operate (hybrid vehicles) may rely on the original equipment manufacturer's (or, in the case of a foreign original equipment manufacturer, its domestic distributor's) certification of the incremental cost of the motor vehicles' clean-fuel vehicle property for purposes of section 179A of the Code.

Announcement 2002–54, page 1190.
This announcement contains the annual report concerning the Pre-Filing Agreement Program of the Large and Mid-Size Division of the Service for calendar year 2001.

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Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 30.—Credit for Qualified Electric Vehicles

If a hybrid motor vehicle is a "qualified electric vehicle", does the motor vehicle constitute "clean-fuel vehicle property" for purposes of section 179A(c) of the Internal Revenue Code? See Rev. Proc. 2002–42, page 1188.

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 50.—Other Special Rules

If a hybrid motor vehicle is used predominantly outside the United States, is a clean-fuel vehicle property deduction allowed with respect to the motor vehicle under section 179A(a) of the Internal Revenue Code? See Rev. Proc. 2002–42, page 1188.

Section 179.—Election to Expense Certain Depreciable Business Assets

If a taxpayer elects to treat the cost of the clean-fuel vehicle property in a hybrid motor vehicle as an expense which is not chargeable to capital account, is a clean-fuel vehicle property deduction allowed with respect to the motor vehicle under section 179A(a) of the Internal Revenue Code? See Rev. Proc. 2002–42, page 1188.

Section 179A.—Deduction for Clean-Fuel Vehicles and Certain Refueling Property

If a motor vehicle is propelled by both a gasoline internal combustion engine and an electric motor that is recharged as the motor vehicle operates and the motor vehicle otherwise meets the requirements of section 179A of the Internal Revenue Code, may taxpayers rely on the manufacturer's certification of the incremental cost of the motor vehicle's clean-fuel vehicle property for purposes of the clean-fuel vehicle property deduction under section 179A of the Internal Revenue Code? See Rev. Proc. 2002–42, page 1188.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 401.—Qualified Pension, Profit-Sharing and Stock Bonus Plans

26 CFR 1.401(a)(9)–1: Required distributions from trusts and plans.

A revenue procedure provides model amendments that may be used in conjunction with the final and temporary Income Tax Regulations published under § 401(a)(9) of the Code which are effective for years beginning on or after January 1, 2003. See Rev. Proc. 2002–29, page 1176.

26 CFR 1.401(b)–1: Certain retroactive changes in plan.

A revenue procedure describes how retroactive remedial plan amendments may be made after the end of the GUST remedial amendment period if certain criteria are met. See Rev. Proc. 2002–35, page 1187.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 441.—Period for Computation of Taxable Income

26 CFR 1.441–1: Period for computation of taxable income.

T.D. 8996

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 5c, 5f, 18, and 602

Changes in Accounting Periods

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to certain adoptions, changes, and retentions of annual accounting periods. The final regulations are necessary to update, clarify, and reorganize the rules and procedures for adopting, changing, and retaining a taxpayer's annual accounting period. The final regulations primarily affect taxpayers that want to adopt an annual accounting period under section 441 or that must receive approval from the Commissioner to adopt, change, or retain their annual accounting periods under section 442.

DATES: *Effective Date*: These regulations are effective May 17, 2002.

Applicability Date: These regulations are applicable for taxable years ending on or after May 17, 2002.

FOR FURTHER INFORMATION CONTACT: Michael Schmit or Roy Hirschhorn at (202) 622-4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1748. Responses to these collections of information are required for certain taxpayers to adopt, change, or retain an annual accounting period.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent varies from 20 minutes to one hour, depending on individual circumstances, with an estimated average of 30 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR: MP:FP:S, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On June 12, 2001, the IRS and Treasury Department published in the **Federal Register** proposed amendments to regulations under section 441 (period for computing taxable income), and sections 442, 706, 898, and 1378 (regarding the requirement to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period) (REG–106917–99, 2001–27 I.R.B. 4 [66 FR 31850]). Written and electronic comments were solicited, and a public hearing was scheduled for October 2, 2001. Several comments were received, and are discussed below. Because no requests to speak were received, the public hearing was cancelled. After consideration of all comments, the proposed regulations under sections 441, 442, 706, and 1378 are adopted as revised by this Treasury decision.

Summary of Comments and Explanation of Revisions

1. *Comments and Changes Relating to § 1.441 of the Proposed Regulations*

A. *Definition of 52–53-week taxable year*

The proposed regulations both define the term *taxable year consisting of 52–53-weeks* and provide an *Example* illustrating a 52–53-week taxable year that ends on a particular day of the week that last occurs in a calendar month or that is nearest to the last day of that calendar month. A commentator observed that many taxpayers have difficulty correctly applying the rules for 52–53-week taxable years, and suggested that certain explanatory text contained in the *Example* be moved to the regulations text itself where it would be more apparent and helpful. This suggestion has been adopted in the final regulations.

B. *Changes to or from a 52–53-week taxable year*

The proposed regulations generally provide that changes to or from a 52–53-week taxable year are treated as changes in annual accounting periods that require the approval of the Commissioner, and describe some specific instances in which such approval may be obtained automatically under administrative procedures to be published by the Commissioner. Consistent with the general framework of the regulations, the descriptions of these specific changes have been removed from the final regulations. Taxpayers should see Rev. Proc. 2002–37, 2002–22 I.R.B. 1030 and Rev. Proc. 2002–38, 2002–22 I.R.B. 1037, for situations in which automatic approval for changes to or from a 52–53-week taxable year will be granted. The final regulations clarify that a taxpayer will not be granted automatic approval for a change from one 52–53-week taxable year to another 52–53-week taxable year, even if both years reference the same calendar month.

C. *Short periods of 6 days or less*

The proposed regulations provide special rules for certain short periods required to effect a change in annual accounting period to (or from) a 52–53-week taxable year. The proposed regulations provide that if the short period is 6 days or less, such short period is not a separate taxable year but is instead added to and deemed a part of the following taxable year.

One commentator suggested that taxpayers be permitted the option of adding such a short period to either: (1) the following taxable year (as the proposed regulations would require); or (2) the prior taxable year, whichever convention is used by the taxpayer for financial accounting purposes.

The IRS and Treasury Department believe that adopting the commentator's suggestion in this case would present certain administrative difficulties, complicate tax administration, and possibly encourage the use of hindsight in tax reporting. After careful consideration, the IRS and Treasury have concluded that it is in the best interests of sound tax administration to have a uniform and certain rule applicable in all such situations. Thus, the final regulations do not adopt this suggestion.

D. *Application of effective date rules to 52–53 week-taxable years*

The proposed regulations provide a general rule concerning the application of certain effective dates as they apply to taxpayers employing 52–53-week taxable years. In response to comments, the final regulations clarify that this rule also applies to administrative guidance published by the Commissioner.

A comment was received suggesting that additional *Examples* be provided illustrating how particular terms other than those "expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month," apply to 52–53-week fiscal-year taxpayers. In response to this comment, clarifying language and an additional *Example* have been provided in the final regulations.

E. *Definitions of "pass-through entity" and "owner of a pass-through entity"*

The proposed regulations provide rules for certain pass-through entities and owners of pass-through entities relating to the treatment of certain taxable years ending with reference to the same calendar month. These rules are designed to prevent substantial deferral and distortion of income reporting.

The IRS and Treasury have become aware of a potentially abusive situation involving the deferral of income reporting in the case of closely-held Real Estate Investment Trusts (REITs) (within the meaning of section 6655(e)(5)(B)) and certain owners of interests in closely-held REITs (within the meaning of section 6655(e)(5)(A)).

For estimated tax purposes, certain owners of interests in closely-held REITs are required to recognize income from the REIT in a manner similar to partners in a partnership. Unlike a partnership, however, REITs are not required to use a taxable year that conforms to the taxable year of their owners but rather are required to use a taxable year ending December 31 pursuant to section 859. Thus, the potential for deferral of estimated taxes exists with respect to certain owners of interests in closely-held REITs, including owners with 52–53-week taxable years that reference December 31, as well as fiscal-year owners.

In an attempt to reduce the potential for deferral of estimated taxes in the case of certain owners of interests in closely-held REITs, the final regulations have been modified to add: (1) a closely-held REIT (within the meaning of section 6655(e)(5)(B)) to the definition of a *pass-through entity*; and (2) an owner of an interest (within the meaning of section 6655(e)(5)(A)) in a closely-held REIT to the definition of an *owner of a pass-through entity*. Thus, these owners of interests in a closely-held REIT with 52–53-week taxable years that reference December 31 will be required under the final regulations to recognize income from the closely-held REIT as if their taxable year ends on December 31.

F. *Accrual of foreign taxes*

The IRS recognizes that changes to the taxable year of a taxpayer may shift the taxable year in which foreign taxes are treated as accruing for U.S. purposes. The IRS also recognizes that similar results may occur in the case of taxpayers that use a 52–53-week taxable year, which will not always include the last day of the taxpayer's taxable year in a foreign jurisdiction. The IRS is working on guidance that it expects will be issued this year to ensure that changes in U.S. taxable years, or the use of a 52–53-week taxable year, do not result in unintended and inappropriate consequences for foreign tax credit purposes. Comments are requested on the changes necessary and appropriate to address the accrual of foreign taxes in these situations.

2. *Comments and Changes Relating to § 1.442 of the Proposed Regulations*

A. *Time and manner for filing an application*

The proposed regulations provide specific rules for the time and manner of filing an application to adopt, change, or retain an annual accounting period. Consistent with the general framework of the regulations, the IRS and Treasury have concluded that it is more appropriate to remove the specific time and manner requirements for filing applications for adoptions, changes, and retentions in annual accounting period from the final regulations, and provide them instead in administrative procedures published by the Commissioner. See Rev. Proc. 2002–37, Rev. Proc. 2002–38, and Rev. Proc. 2002–39, 2002–22 I.R.B. 1046. The IRS and Treasury believe that providing these rules in administrative guidance, rather than in regulations, allows the IRS more flexibility to respond in the future to the changing needs of taxpayers and the IRS.

The proposed regulations provide that an application for non-automatic approval of an annual accounting period change may be filed no earlier than the day following the close of the first effective year and no later than the 15th day of the third calendar month following the close of the first effective year. One commentator suggested that such applications be permitted to be filed no earlier than the later of: (1) the first day of the short period resulting from the proposed tax year change; or (2) 60 days prior to the end of the short period.

The IRS currently allows taxpayers to file applications with the national office within the referenced 60-day period and believes that many taxpayers take advantage of early filing, even knowing that their applications lack adequate information, in an effort to obtain priority over other applications processed by the national office. However, the lack of adequate financial and other required information common to such early applications requires that the IRS devote additional resources to properly develop and process the applications. Ultimately, this causes a delay in processing both the early applications, and other applications as well. For this reason, the administrative guidance issued concurrently with these final regulations do not adopt this suggestion. However, the IRS and Treasury Department intend to study filing patterns under the new rules, and will consider expanding or modifying the time frame for filing applications with the national office if circumstances warrant.

One commentator recommended that instead of requiring all taxpayers to file the application by the 15th day of the third calendar month following the close of the first taxable year in which the taxpayer wants the adoption, change, or retention to be effective (the first effective year), as the proposed regulations provide, the due date for the application should be the due date of the taxpayer's return for the short period, without extensions. The IRS and Treasury believe that such a rule will be simpler for taxpayers (such as individuals and partnerships) and the IRS. Accordingly, this change is adopted in the administrative guidance issued concurrently with these final regulations.

B. *Changes to required taxable years by pass-through entities*

One commentator suggested that the proposed regulations be modified to waive the Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, filing requirement in the case of partnerships, S corporations, and personal service corporations (PSCs) changing to a "required taxable year" for the first taxable year for which such change is required. Alternatively, the commentator recommended use of an "automatic consent" procedure similar to the procedure

outlined in the proposed regulations for subsidiaries changing tax years to conform to the periods of their affiliated groups. The commentator reasoned that changes to statutorily required taxable years should not require the Commissioner's prior approval through any filing or application process.

Except in very limited circumstances (*e.g.*, adoptions of required years, certain section 444 terminations, and certain section 859 changes) applications historically have been required for changes to a required taxable year by a pass-through entity. The IRS and Treasury Department believe that the statutes that require such entities to use or change to a particular taxable year must be read in conjunction with the general requirement under section 442 to obtain the prior approval of the Commissioner to change an existing taxable year. Moreover, the applications serve to provide the IRS with necessary information about the entity's annual accounting period. Accordingly, this comment was not adopted in the final regulations or the administrative guidance issued concurrently with these regulations.

C. *Book conformity requirements*

The proposed regulations conform the recordkeeping requirement for taxpayers using a fiscal year to that of § 1.446–1(a)(4), which allows for a reconciliation between the taxpayer's books and return. However, the preamble to the proposed regulations noted that, as a term and condition of obtaining approval to adopt, change to, or retain an annual accounting period under section 442, certain taxpayers nevertheless may be required, under administrative procedures published by the Commissioner, to compute income and keep their books (including financial statements and reports to creditors) on the basis of the requested annual accounting period. In fact, strict book conformity is a general requirement in the administrative procedures for approval to make many changes. See, *e.g.*, Rev. Proc. 2002–37.

One commentator objected to the proposed elimination of procedures contained in the existing regulations under section 442 under which certain corporations are granted automatic approval to change their taxable year without a strict book conformity requirement (*i.e.*, by satisfying the general book conformity rules of section 446). The commentator recommended that either the final regulations retain these automatic consent rules or, alternatively, that the administrative procedures eliminate the strict book conformity requirement.

The IRS and Treasury Department believe it is appropriate to apply the more lenient book conformity rule of section 446 in the case of a taxpayer adopting, changing to, or retaining a required or ownership taxable year and in the case of a foreign corporation that is required by foreign law to use a particular year for financial accounting purposes. See, *e.g.*, Rev. Proc. 2002–39. However, for all other changes under the administrative procedures, the IRS and Treasury Department continue to believe that strict book conformity is an appropriate term and condition of a voluntary change in annual accounting period, as it provides assurance that the change is motivated by business, as opposed to tax, considerations. In addition, the IRS and Treasury believe, for reasons stated in the preamble to the proposed regulations, that tax administration and taxpayers are better served by providing the specific rules for adoptions, changes, and retentions of annual accounting periods in administrative pronouncements, rather than regulations. Accordingly, the comment has not been adopted.

3. *Comments and Changes Relating to Partnerships, S Corporations, and Personal Service Corporations (PSCs)*

A comment was received recommending that the limitation on additional required taxable year changes in the proposed regulations for partnerships using a majority-interest taxable years, be extended to partnerships using other required taxable years (*e.g.*, to principal partners' taxable years and to least-aggregate-deferral taxable years). The limitation for changes to a majority interest taxable year is specifically provided in section 706(b)(4)(B). No such statutory authority exists for providing similar limitations in the case of other required taxable year changes by partnerships. Accordingly, this comment was not adopted in the final regulations. However, the Treasury Department is considering this comment in connection with a legis lative simplification study.

The proposed regulations (consisten with the existing temporary regulations generally provide for a 1-year testin period for determining whether a tax payer is a PSC. In the preamble to th proposed regulations, the IRS and Trea sury Department responded to a commen received in connection with the origina notice of proposed rulemaking cross referenced by the temporary regulation The original commentator suggested th the testing period be expanded to th three preceding taxable years in order t minimize instances in which taxpayer become PSCs due to temporary or aberra tional conditions. In response, the IR and Treasury Department indicated th they would consider alternatives to th current 1-year period if similar request were received in comments to the pro posed regulations now that taxpayer have significantly more experience wit the 1-year rule.

Although some comments wer received recommending a general 3-yea testing period for both PSCs and S corpo rations, the suggestions were not directe to particular taxpayer burdens stemmin from the 1-year testing period for a PS or the original concern about taxpayer becoming a PSC because of temporary o aberrational conditions. Rather, commen tators suggested that a general 3-year test ing period rule would reduce repetitiv "required tax year" changes, and promot tax-year certainty.

The IRS and Treasury Departmen believe that these reasons do not warran extending the 1-year testing period fo PSCs and S corporations because the cur rent required taxable year framework fo PSCs and S corporations should not resul in repetitive required taxable yea changes. Once a PSC or S corporatio has changed to its required taxable yea (*i.e.*, a calendar year), any further change would be voluntary rather than require Accordingly, this suggestion has not bee adopted in the final regulations.

Effect on Other Documents

Rev. Rul. 57–589 is obsolete.

Rev. Rul. 65–316 (1965–2 C.B. 149) i obsolete.

Rev. Rul. 68–125 (1968–1 C.B. 189) i obsolete.

Rev. Rul. 69–563 is obsolete.

Rev. Rul. 74–326 (1974–2 C.B. 142) is obsolete.

Rev. Rul. 78–179 (1978–1 C.B. 132) is obsolete.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few small entities are expected to adopt a 52–53-week taxable year, triggering the collection of information, and that for those who do, the burden imposed under § 1.441–2(b)(1)(ii) will be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Roy A. Hirschhorn and Michael F. Schmit of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 5c, 5f, 18, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In the list below, for each section indicated in the left column, remove the old language in the middle column and add the new language in the right column.

Affected Section	Remove	Add
1.46–1(p)(2)(iv)	paragraph (b)(1) of § 1.441–2	§ 1.441–2
1.48–3(d)(1)(iii)	paragraph (b)(1) of § 1.441–2	§ 1.441–2
1.280H–1T(a), last sentence	§ 1.441–4T(d)	§ 1.441-3(c)
1.443–1(b)(1)(ii)	and paragraph (c)(5) of § 1.441–2	and § 1.441–2(b)(2)(ii).
1.444–1T(a)(1), first sentence	§ 1.441–4T(d)	§ 1.441-3(c)
1.444–2T(a), last sentence	§ 1.441–4T(d)	§ 1.441-3(c)
1.448–1(h)(2)(ii)(B)(*1*)	§ 1.441–2T(b)(1)	§ 1.441-2(c)
1.469–1(h)(4)(ii)(D)	§ 1.441–4T(f)	§ 1.441-3(e)
1.469–1T(g)(2)(i)	§ 1.441–4T(d)	§ 1.441-3(c)
1.1561–1(c)(2)	See paragraph (b)(1) of § 1.441–2	See § 1.441–2
1.6654–2(a), concluding text	paragraph (b) of § 1.441–2	§ 1.441-2(c)
1.6655–2(a)(4), first sentence	paragraph (b) of § 1.441–2	§ 1.441-2(c)
301.7701(b)–6(a), third sentence	§ 1.441–1(e)	§ 1.441–1(b)

Par. 3. Sections 1.441–0, 1.441–1, 1.441–2, 1.441–3, and 1.441–4 are added to read as follows:

§ 1.441–0 Table of contents.

This section lists the captions contained in §§ 1.441–1 through 1.441–4 as follows:

§ 1.441–1 Period for computation of taxable income.

§ 1.441–2 Election of taxable year consisting of 52–53 weeks.

(a) In general.
(1) Election.
(2) Effect.
(3) Eligible taxpayer.
(4) Example.
(b) Procedures to elect a 52–53-week taxable year.
(1) Adoption of a 52–53-week taxable year.
(i) In general.
(ii) Filing requirement.
(2) Change to (or from) a 52–53-week taxable year.
(i) In general.
(ii) Special rules for short period required to effect the change.
(3) Examples.
(c) Application of effective dates.
(1) In general.
(2) Examples.
(3) Changes in tax rates.
(4) Examples.
(d) Computation of taxable income.
(e) Treatment of taxable years ending with reference to the same calendar month.
(1) Pass-through entities.
(2) Personal service corporations and employee-owners.
(3) Definitions.
(i) Pass-through entity.
(ii) Owner of a pass-through entity.
(4) Examples.
(5) Transition rule.

§ 1.441–3 Taxable year of a personal service corporation.

(a) Taxable year.
(1) Required taxable year.
(2) Exceptions.
(b) Adoption, change, or retention of taxable year.
(1) Adoption of taxable year.
(2) Change in taxable year.
(3) Retention of taxable year.
(4) Procedures for obtaining approval or making a section 444 election.
(5) Examples.
(c) Personal service corporation defined.
(1) In general.
(2) Testing period.
(i) In general.
(ii) New corporations.
(3) Examples.
(d) Performance of personal services.
(1) Activities described in section 448(d)(2)(A).
(2) Activities not described in section 448(d)(2)(A).
(e) Principal activity.
(1) General rule.
(2) Compensation cost.
(i) Amounts included.
(ii) Amounts excluded.
(3) Attribution of compensation cost to personal service activity.
(i) Employees involved only in the performance of personal services.
(ii) Employees involved only in activities that are not treated as the performance of personal services.
(iii) Other employees.
(A) Compensation cost attributable to personal service activity.
(B) Compensation cost not attributable to personal service activity.
(f) Services substantially performed by employee-owners.
(1) General rule.
(2) Compensation cost attributable to personal services.
(3) Examples.
(g) Employee-owner defined.
(1) General rule.
(2) Special rule for independent contractors who are owners.
(h) Special rules for affiliated groups filing consolidated returns.
(1) In general.
(2) Examples.

§ 1.441–4 Effective date.

§ 1.441–1 Period for computation of taxable income.

(a) *Computation of taxable income*—(1) *In general.* Taxable income must be computed and a return must be made for a period known as the taxable year. For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see parts II and III (section 446 and following), subchapter E, chapter 1 of the Internal Revenue Code, and the regulations thereunder.

(2) *Length of taxable year.* Except as otherwise provided in the Internal Revenue Code and the regulations thereunder (*e.g.*, § 1.441–2 regarding 52–53-week taxable years), a taxable year may not cover a period of more than 12 calendar months.

(b) *General rules and definitions.* The general rules and definitions in this paragraph (b) apply for purposes of sections 441 and 442 and the regulations thereunder.

(1) *Taxable year. Taxable year* means—

(i) The period for which a return is made, if a return is made for a period of less than 12 months (short period). See section 443 and the regulations thereunder;

(ii) Except as provided in paragraph (b)(1)(i) of this section, the taxpayer's required taxable year (as defined in paragraph (b)(2) of this section), if applicable;

(iii) Except as provided in paragraphs (b)(1)(i) and (ii) of this section, the taxpayer's annual accounting period (as defined in paragraph (b)(3) of this section), if it is a calendar year or a fiscal year; or

(iv) Except as provided in paragraphs (b)(1)(i) and (ii) of this section, the calendar year, if the taxpayer keeps no books, does not have an annual accounting period, or has an annual accounting period that does not qualify as a fiscal year.

(2) *Required taxable year*—(i) *In general.* Certain taxpayers must use the particular taxable year that is required under the Internal Revenue Code and the regulations thereunder (the required taxable year). For example, the required taxable year is—

(A) In the case of a foreign sales corporation or domestic international sales corporation, the taxable year determined under section 441(h) and § 1.921–1T(a)(11), (b)(4), and (b)(6);

(B) In the case of a personal service corporation (PSC), the taxable year determined under section 441(i) and § 1.441–3;

(C) In the case of a nuclear decommissioning fund, the taxable year determined under § 1.468A–4(c)(1);

(D) In the case of a designated settlement fund or a qualified settlement fund, the taxable year determined under § 1.468B–2(j);

(E) In the case of a common trust fund, the taxable year determined under section 584(i);

(F) In the case of certain trusts, the taxable year determined under section 644;

(G) In the case of a partnership, the taxable year determined under section 706 and § 1.706–1;

(H) In the case of an insurance company, the taxable year determined under section 843 and § 1.1502–76(a)(2);

(I) In the case of a real estate investment trust, the taxable year determined under section 859;

(J) In the case of a real estate mortgage investment conduit, the taxable year determined under section 860D(a)(5) and § 1.860D–1(b)(6);

(K) In the case of a specified foreign corporation, the taxable year determined under section 898(c)(1)(A);

(L) In the case of an S corporation, the taxable year determined under section 1378 and § 1.1378–1; or

(M) In the case of a member of an affiliated group that makes a consolidated return, the taxable year determined under § 1.1502–76.

(ii) *Exceptions*. Notwithstanding paragraph (b)(2)(i) of this section, the following taxpayers may have a taxable year other than their required taxable year:

(A) *52–53-week taxable years*. Certain taxpayers may elect to use a 52–53-week taxable year that ends with reference to their required taxable year. See, for example, §§ 1.441–3 (PSCs), 1.706–1 (partnerships), 1.1378–1 (S corporations), and 1.1502–76(a)(1) (members of a consolidated group).

(B) *Partnerships, S corporations, and PSCs*. A partnership, S corporation, or PSC may use a taxable year other than its required taxable year if the taxpayer elects to use a taxable year other than its required taxable year under section 444, elects a 52–53-week taxable year that ends with reference to its required taxable year as provided in paragraph (b)(2)(ii)(A) of this section or to a taxable year elected under section 444, or establishes a business purpose to the satisfaction of the Commissioner under section 442 (such as a grandfathered fiscal year).

(C) *Specified foreign corporations*. A specified foreign corporation (as defined in section 898(b)) may use a taxable year other than its required taxable year if it elects a 52–53-week taxable year that ends with reference to its required taxable year as provided in paragraph (b)(2)(ii)(A) of this section or makes a one-month deferral election under section 898(c)(1)(B).

(3) *Annual accounting period*. *Annual accounting period* means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

(4) *Calendar year*. *Calendar year* means a period of 12 consecutive months ending on December 31. A taxpayer who has not established a fiscal year must make its return on the basis of a calendar year.

(5) *Fiscal year*—(i) *Definition*. *Fiscal year* means—

(A) A period of 12 consecutive months ending on the last day of any month other than December; or

(B) A 52–53-week taxable year, if such period has been elected by the taxpayer. See § 1.441–2.

(ii) *Recognition*. A fiscal year will be recognized only if the books of the taxpayer are kept in accordance with such fiscal year.

(6) *Grandfathered fiscal year*. *Grandfathered fiscal year* means a fiscal year (other than a year that resulted in a three month or less deferral of income) that a partnership or an S corporation received permission to use on or after July 1, 1974, by a letter ruling (*i.e.*, not by automatic approval).

(7) *Books*. *Books* include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on the taxpayer's books and on the taxpayer's return, as for example, a reconciliation of any difference between such books and the taxpayer's return. Records that are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. See section 6001 and the regulations thereunder for rules relating to the keeping of books and records.

(8) *Taxpayer*. *Taxpayer* has the same meaning as the term *person* as defined in section 7701(a)(1) (*e.g.*, an individual, trust, estate, partnership, association, or corporation) rather than the meaning of the term taxpayer as defined in section 7701(a)(14) (any person subject to tax).

(c) *Adoption of taxable year*—(1) *In general*. Except as provided in paragraph (c)(2) of this section, a new taxpayer may adopt any taxable year that satisfies the requirements of section 441 and the regulations thereunder without the approval of the Commissioner. A taxable year of a new taxpayer is adopted by filing its first Federal income tax return using that taxable year. The filing of an application for automatic extension of time to file a Federal income tax return (*e.g.*, Form 7004, *"Application for Automatic Extension of Time To File Corporation Income Tax Return"*), the filing of an application for an employer identification number (*i.e.*, Form SS-4, *"Application for Employer Identification Number")*, or the payment of estimated taxes, for a particular taxable year do not constitute an adoption of that taxable year.

(2) *Approval required*—(i) *Taxpayers with required taxable years*. A newly-formed partnership, S corporation, or PSC that wants to adopt a taxable year other than its required taxable year, a taxable year elected under section 444, or a 52–53-week taxable year that ends with reference to its required taxable year or a taxable year elected under section 444 must establish a business purpose and obtain the approval of the Commissioner under section 442.

(ii) *Taxpayers without books*. A taxpayer that must use a calendar year under section 441(g) and paragraph (f) of this section may not adopt a fiscal year without obtaining the approval of the Commissioner.

(d) *Retention of taxable year*. In certain cases, a partnership, S corporation, electing S corporation, or PSC will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that either becomes a PSC or elects to be an S corporation and, as a result, is required to use the calendar year under section 441(i) or 1378, respectively, must obtain the approval of the Commissioner to retain its current fiscal year. Similarly, a partnership using a taxable year that corresponds to its required taxable year must obtain the approval of the Commissioner to retain such taxable year if its required taxable year changes as a result of a

change in ownership. However, a partnership that previously established a business purpose to the satisfaction of the Commissioner to use a taxable year is not required to obtain the approval of the Commissioner if its required taxable year changes as a result of a change in ownership.

(e) *Change of taxable year*. Once a taxpayer has adopted a taxable year, such taxable year must be used in computing taxable income and making returns for all subsequent years unless the taxpayer obtains approval from the Commissioner to make a change or the taxpayer is otherwise authorized to change without the approval of the Commissioner under the Internal Revenue Code (*e.g.*, section 444 or 859) or the regulations thereunder.

(f) *Obtaining approval of the Commissioner or making a section 444 election*. See § 1.442–1(b) for procedures for obtaining approval of the Commissioner (automatically or otherwise) to adopt, change, or retain an annual accounting period. See §§ 1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

§ 1.441–2 Election of taxable year consisting of 52–53 weeks.

(a) *In general*—(1) *Election*. An eligible taxpayer may elect to compute its taxable income on the basis of a fiscal year that—

(i) Varies from 52 to 53 weeks;

(ii) Ends always on the same day of the week; and

(iii) Ends always on—

(A) Whatever date this same day of the week last occurs in a calendar month; or

(B) Whatever date this same day of the week falls that is the nearest to the last day of the calendar month.

(2) *Effect*. In the case of a taxable year described in paragraph (a)(1)(iii)(A) of this section, the year will always end within the month and may end on the last day of the month, or as many as six days before the end of the month. In the case of a taxable year described in paragraph (a)(1)(iii)(B) of this section, the year may end on the last day of the month, or as many as three days before or three days after the last day of the month.

(3) *Eligible taxpayer*. A taxpayer is eligible to elect a 52–53-week taxable year if such fiscal year would otherwise satisfy the requirements of section 441 and the regulations thereunder. For example, a taxpayer that is required to use a calendar year under § 1.441–1(b)(2)(i)(D) is not an eligible taxpayer.

(4) *Example*. The provisions of this paragraph (a) are illustrated by the following example:

Example. If the taxpayer elects a taxable year ending always on the last Saturday in November, then for the year 2001, the taxable year would end on November 24, 2001. On the other hand, if the taxpayer had elected a taxable year ending always on the Saturday nearest to the end of November, then for the year 2001, the taxable year would end on December 1, 2001.

(b) *Procedures to elect a 52–53-week taxable year*—(1) *Adoption of a 52–53-week taxable year*—(i) *In general*. A new eligible taxpayer elects a 52–53-week taxable year by adopting such year in accordance with § 1.441–1(c). A newly-formed partnership, S corporation or personal service corporation (PSC) may adopt a 52–53-week taxable year without the approval of the Commissioner if such year ends with reference to either the taxpayer's required taxable year (as defined in § 1.441-1(b)(2)) or the taxable year elected under section 444. See §§ 1.441–3, 1.706–1, and 1.1378–1. Similarly, a newly-formed specified foreign corporation (as defined in section 898(b)) may adopt a 52–53-week taxable year if such year ends with reference to the taxpayer's required taxable year, or, if the one-month deferral election under section 898(c)(1)(B) is made, with reference to the month immediately preceding the required taxable year. See § 1.1502–76(a)(1) for special rules regarding subsidiaries adopting 52–53-week taxable years.

(ii) *Filing requirement*. A taxpayer adopting a 52–53-week taxable year must file with its Federal income tax return for its first taxable year a statement containing the following information—

(A) The calendar month with reference to which the 52–53-week taxable year ends;

(B) The day of the week on which the 52–53-week taxable year always will end; and

(C) Whether the 52–53-week taxable year will always end on the date on which that day of the week last occurs in the calendar month, or on the date on which that day of the week falls that is nearest to the last day of that calendar month.

(2) *Change to (or from) a 52–53-week taxable year*—(i) *In general*. An election of a 52–53-week taxable year by an existing eligible taxpayer with an established taxable year is treated as a change in annual accounting period that requires the approval of the Commissioner in accordance with § 1.442–1. Thus, a taxpayer must obtain approval to change from its current taxable year to a 52–53-week taxable year, even if such 52–53-week taxable year ends with reference to the same calendar month. Similarly, a taxpayer must obtain approval to change from a 52–53-week taxable year, or to change from one 52–53-week taxable year to another 52–53-week taxable year. However, a taxpayer may obtain approval for 52–53-week taxable year changes automatically to the extent provided in administrative procedures published by the Commissioner. See § 1.442–1(b) for procedures for obtaining such approval.

(ii) *Special rules for the short period required to effect the change*. If a change to or from a 52–53-week taxable year results in a short period (within the meaning of § 1.443–1(a)) of 359 days or more, or six days or less, the tax computation under § 1.443–1(b) does not apply. If the short period is 359 days or more, it is treated as a full taxable year. If the short period is six days or less, such short period is not a separate taxable year but instead is added to and deemed a part of the following taxable year. (In the case of a change to or from a 52–53-week taxable year not involving a change of the month with reference to which the taxable year ends, the tax computation under § 1.443–1(b) does not apply because the short period will always be 359 days or more, or six days or less.) In the case of a short period which is more than six days and less than 359 days, taxable income for the short period is placed on an annual basis for purposes of § 1.443–1(b) by multiplying such income by 365 and dividing the result by the number of days in the short period. In such case, the tax for the short period is the same part of the tax computed on such income placed on an annual basis as the number of days in the short period is of 365 days (unless § 1.443–1(b)(2), relating to the alternative

tax computation, applies). For an adjustment in deduction for personal exemption, see § 1.443–1(b)(1)(v).

(3) *Examples*. The following examples illustrate paragraph (b)(2)(ii) of this section:

Example 1. A taxpayer having a fiscal year ending April 30, obtains approval to change to a 52–53-week taxable year ending the last Saturday in April for taxable years beginning after April 30, 2001. This change involves a short period of 362 days, from May 1, 2001, to April 27, 2002, inclusive. Because the change results in a short period of 359 days or more, it is not placed on an annual basis and is treated as a full taxable year.

Example 2. Assume the same conditions as *Example 1*, except that the taxpayer changes for taxable years beginning after April 30, 2002, to a taxable year ending on the Thursday nearest to April 30. This change results in a short period of two days, May 1 to May 2, 2002. Because the short period is less than seven days, tax is not separately computed. This short period is added to and deemed part of the following 52–53-week taxable year, which would otherwise begin on May 3, 2002, and end on May 1, 2003.

(c) *Application of effective dates*—(1) *In general*. Except as provided in paragraph (c)(3) of this section, for purposes of determining the effective date (*e.g.*, of legislative, regulatory, or administrative changes) or the applicability of any provision of the internal revenue laws that is expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, a 52–53-week taxable year is deemed to begin on the first day of the calendar month nearest to the first day of the 52–53-week taxable year, and is deemed to end or close on the last day of the calendar month nearest to the last day of the 52–53-week taxable year, as the case may be. Examples of provisions of this title, the applicability of which is expressed in terms referred to in the preceding sentence, include the provisions relating to the time for filing returns and other documents, paying tax, or performing other acts, and the provisions of part II, subchapter B, chapter 6 (section 1561 and following) relating to surtax exemptions of certain controlled corporations.

(2) *Examples*. The provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example 1. Assume that an income tax provision is applicable to taxable years beginning on or after January 1, 2001. For that purpose, a 52–53-week taxable year beginning on any day within the period December 26, 2000, to January 4, 2001, inclusive, is treated as beginning on January 1, 2001.

Example 2. Assume that an income tax provision requires that a return must be filed on or before the 15th day of the third month following the close of the taxable year. For that purpose, a 52–53-week taxable year ending on any day during the period May 25 to June 3, inclusive, is treated as ending on May 31, the last day of the month ending nearest to the last day of the taxable year, and the return, therefore, must be made on or before August 15.

Example 3. Assume that a revenue procedure requires the performance of an act by the taxpayer within "the first 90 days of the taxable year," by "the 75th day of the taxable year," or, alternately, by "the last day of the taxable year." The taxpayer employs a 52–53-week taxable year that ends always on the Saturday closest to the last day of December. These requirements are not expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, and are accordingly outside the scope of the rule stated in § 1.441–2(c)(1). Accordingly, the taxpayer must perform the required act by the 90th, 75th, or last day, respectively, of its taxable year.

Example 4. X, a corporation created on January 1, 2001, elects a 52–53-week taxable year ending on the Friday nearest the end of December. Thus, X's first taxable year begins on Monday, January 1, 2001, and ends on Friday, December 28, 2001; its next taxable year begins on Saturday, December 29, 2001, and ends on Friday, January 3, 2003; and its next taxable year begins on Saturday, January 4, 2003, and ends on Friday, January 2, 2004. For purposes of applying the provisions of Part II, subchapter B, chapter 6 of the Internal Revenue Code, X's first taxable year is deemed to end on December 31, 2001; its next taxable year is deemed to begin on January 1, 2002, and end on December 31, 2002, and its next taxable year is deemed to begin on January 1, 2003, and end on December 31, 2003. Accordingly, each such taxable year is treated as including one and only one December 31st.

(3) *Changes in tax rates*. If a change in the rate of tax is effective during a 52–53-week taxable year (other than on the first day of such year as determined under paragraph (c)(1) of this section), the tax for the 52–53-week taxable year must be computed in accordance with section 15, relating to effect of changes, and the regulations thereunder. For the purpose of the computation under section 15, the determination of the number of days in the period before the change, and in the period on and after the change, is to be made without regard to the provisions of paragraph (b)(1) of this paragraph.

(4) *Examples*. The provisions of paragraph (c)(3) of this section may be illustrated by the following examples:

Example 1. Assume a change in the rate of tax is effective for taxable years beginning after June 30, 2002. For a 52–53-week taxable year beginning on Friday, November 2, 2001, the tax must be computed on the basis of the old rates for the actual number of days from November 2, 2001, to June 30, 2002, inclusive, and on the basis of the new rates for the actual number of days from July 1, 2002, to Thursday, October 31, 2002, inclusive.

Example 2. Assume a change in the rate of tax is effective for taxable years beginning after June 30, 2001. For this purpose, a 52–53-week taxable year beginning on any of the days from June 25 to July 4, inclusive, is treated as beginning on July 1. Therefore, no computation under section 15 will be required for such year because of the change in rate.

(d) *Computation of taxable income*. The principles of section 451, relating to the taxable year for inclusion of items of gross income, and section 461, relating to the taxable year for taking deductions, generally are applicable to 52–53-week taxable years. Thus, except as otherwise provided, all items of income and deduction must be determined on the basis of a 52–53-week taxable year. However, a taxpayer may determine particular items as though the 52–53-week taxable year were a taxable year consisting of 12 calendar months, provided that practice is consistently followed by the taxpayer and clearly reflects income. For example, an allowance for depreciation or amortization may be determined on the basis of a 52–53-week taxable year, or as though the 52–53-week taxable year is a taxable year consisting of 12 calendar months, provided the taxpayer consistently follows that practice with respect to all depreciable or amortizable items.

(e) *Treatment of taxable years ending with reference to the same calendar month*—(1) *Pass-through entities*. If a pass-through entity (as defined in paragraph (e)(3)(i) of this section) or an owner of a pass-through entity (as defined in paragraph (e)(3)(ii) of this section), or both, use a 52–53-week taxable year and the taxable year of the pass-through entity and the owner end with reference to the same calendar month, then, for purposes of determining the taxable year in which items of income, gain, loss, deductions, or credits from the pass-through entity are taken into account by the owner of the pass-through, the owner's taxable year will be deemed to end on the last day of the pass-through's taxable year. Thus, if the taxable year of a partnership and a partner end with reference to the same calendar month, then for purposes of determining the taxable year in which that partner takes into account items described in section 702 and items that are deductible by the partnership (including items

described in section 707(c)) and includible in the income of that partner, that partner's taxable year will be deemed to end on the last day of the partnership's taxable year. Similarly, if the taxable year of an S corporation and a shareholder end with reference to the same calendar month, then for purposes of determining the taxable year in which that shareholder takes into account items described in section 1366(a) and items that are deductible by the S corporation and includible in the income of that shareholder, that shareholder's taxable year will be deemed to end on the last day of the S corporation's taxable year.

(2) *Personal service corporations and employee-owners.* If the taxable year of a PSC (within the meaning of § 1.441–3(c)) and an employee-owner (within the meaning of § 1.441–3(g)) end with reference to the same calendar month, then for purposes of determining the taxable year in which an employee-owner takes into account items that are deductible by the PSC and includible in the income of the employee-owner, the employee-owner's taxable year will be deemed to end on the last day of the PSC's taxable year.

(3) *Definitions*—(i) *Pass-through entity.* For purposes of this section, a pass-through entity means a partnership, S corporation, trust, estate, closely-held real estate investment trust (within the meaning of section 6655(e)(5)(B)), common trust fund (within the meaning of section 584(i)), controlled foreign corporation (within the meaning of section 957), foreign personal holding company (within the meaning of section 552), or passive foreign investment company that is a qualified electing fund (within the meaning of section 1295).

(ii) *Owner of a pass-through entity.* For purposes of this section, an owner of a pass-through entity generally means a taxpayer that owns an interest in, or stock of, a pass-through entity. For example, an owner of a pass-through entity includes a partner in a partnership, a shareholder of an S corporation, a beneficiary of a trust or an estate, an owner of a closely-held real estate investment trust (within the meaning of section 6655(e)(5)(A)), a participant in a common trust fund, a U.S. shareholder (as defined in section 951(b)) of a controlled foreign corporation, a U.S. shareholder (as defined in section 551(a)) of a foreign personal holding company, or a U.S. person that holds stock in a passive foreign investment company that is a qualified electing fund with respect to that shareholder.

(4) *Examples.* The provisions of paragraph (e)(2) of this section may be illustrated by the following examples:

Example 1. ABC Partnership uses a 52–53-week taxable year that ends on the Wednesday nearest to December 31, and its partners, A, B, and C, are individual calendar year taxpayers. Assume that, for ABC's taxable year ending January 3, 2001, each partner's distributive share of ABC's taxable income is $10,000. Under section 706(a) and paragraph (e)(1) of this section, for the taxable year ending December 31, 2000, A, B, and C each must include $10,000 in income with respect to the ABC year ending January 3, 2001. Similarly, if ABC makes a guaranteed payment to A on January 2, 2001, A must include the payment in income for A's taxable year ending December 31, 2000.

Example 2. X, a PSC, uses a 52–53-week taxable year that ends on the Wednesday nearest to December 31, and all of the employee-owners of X are individual calendar year taxpayers. Assume that, for its taxable year ending January 3, 2001, X pays a bonus of $10,000 to each employee-owner on January 2, 2001. Under paragraph (e)(2) of this section, each employee-owner must include its bonus in income for the taxable year ending December 31, 2000.

(5) *Transition rule.* In the case of an owner of a pass-through entity (other than the owner of a partnership or S corporation) that is required by this paragraph (e) to include in income for its first taxable year ending on or after May 17, 2002, amounts attributable to two taxable years of a pass-through entity, the amount that otherwise would be required to be included in income for such first taxable year by reason of this paragraph (e) should be included in income ratably over the four-taxable-year period beginning with such first taxable year under principles similar to § 1.702–3T, unless the owner of the pass-through entity elects to include all such income in its first taxable year ending on or after May 17, 2002.

§ 1.441–3 Taxable year of a personal service corporation.

(a) *Taxable year*—(1) *Required taxable year.* Except as provided in paragraph (a)(2) of this section, the taxable year of a personal service corporation (PSC) (as defined in paragraph (c) of this section) must be the calendar year.

(2) *Exceptions.* A PSC may have a taxable year other than its required taxable year (*i.e.*, a fiscal year) if it makes an election under section 444, elects to use a 52–53-week taxable year that ends with reference to the calendar year or a taxable year elected under section 444, or establishes a business purpose for such fiscal year and obtains the approval of the Commissioner under section 442.

(b) *Adoption, change, or retention of taxable year*—(1) *Adoption of taxable year.* A PSC may adopt, in accordance with § 1.441–1(c), the calendar year, a taxable year elected under section 444, or a 52–53-week taxable year ending with reference to the calendar year or a taxable year elected under section 444 without the approval of the Commissioner. See § 1.441–1. A PSC that wants to adopt any other taxable year must establish a business purpose and obtain the approval of the Commissioner under section 442.

(2) *Change in taxable year.* A PSC that wants to change its taxable year must obtain the approval of the Commissioner under section 442 or make an election under section 444. However, a PSC may obtain automatic approval for certain changes, including a change to the calendar year or to a 52–53-week taxable year ending with reference to the calendar year, pursuant to administrative procedures published by the Commissioner.

(3) *Retention of taxable year.* In certain cases, a PSC will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that becomes a PSC and, as a result, is required to use the calendar year must obtain the approval of the Commissioner to retain its current fiscal year.

(4) *Procedures for obtaining approval or making a section 444 election.* See § 1.442–1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

(5) *Examples.* The provisions of paragraph (b)(4) of this section may be illustrated by the following examples:

Example 1. X, whose taxable year ends on January 31, 2001, becomes a PSC for its taxable year beginning February 1, 2001, and does not obtain the approval of the Commissioner for using a fiscal

year. Thus, for taxable years ending before February 1, 2001, this section does not apply with respect to X. For its taxable year beginning on February 1, 2001, however, X will be required to comply with paragraph (a) of this section. Thus, unless X obtains approval of the Commissioner to use a January 31 taxable year, or makes a section 444 election, X will be required to change its taxable year to the calendar year under paragraph (b) of this section by using a short taxable year that begins on February 1, 2001, and ends on December 31, 2001. Under paragraph (b)(1) of this section, X may obtain automatic approval to change its taxable year to a calendar year. See § 1.442–1(b).

Example 2. Assume the same facts as in *Example 1*, except that X desires to change to a 52–53-week taxable year ending with reference to the month of December. Under paragraph (b)(1) of this section X may obtain automatic approval to make the change. See § 1.442–1(b).

(c) *Personal service corporation defined*—(1) *In general*. For purposes of this section and section 442, a taxpayer is a PSC for a taxable year only if—

(i) The taxpayer is a C corporation (as defined in section 1361(a)(2)) for the taxable year;

(ii) The principal activity of the taxpayer during the testing period is the performance of personal services;

(iii) During the testing period, those services are substantially performed by employee-owners (as defined in paragraph (g) of this section); and

(iv) Employee-owners own (as determined under the attribution rules of section 318, except that the language "any" applies instead of "50 percent" in section 318(a)(2)(C)) more than 10 percent of the fair market value of the outstanding stock in the taxpayer on the last day of the testing period.

(2) *Testing period*—(i) *In general*. Except as otherwise provided in paragraph (c)(2)(ii) of this section, the testing period for any taxable year is the immediately preceding taxable year.

(ii) *New corporations*. The testing period for a taxpayer's first taxable year is the period beginning on the first day of that taxable year and ending on the earlier of—

(A) The last day of that taxable year; or

(B) The last day of the calendar year in which that taxable year begins.

(3) *Examples*. The provisions of paragraph (c)(2)(ii) of this section may be illustrated by the following examples:

Example 1. Corporation A's first taxable year begins on June 1, 2001, and A desires to use a September 30 taxable year. However, if A is a personal service corporation, it must obtain the Commissioner's approval to use a September 30 taxable year. Pursuant to paragraph (c)(2)(ii) of this section, A's testing period for its first taxable year beginning June 1, 2001, is the period June 1, 2001, through September 30, 2001. Thus, if, based upon such testing period, A is a personal service corporation, A must obtain the Commissioner's permission to use a September 30 taxable year.

Example 2. The facts are the same as in *Example 1*, except that A desires to use a March 31 taxable year. Pursuant to paragraph (c)(2)(ii) of this section, A's testing period for its first taxable year beginning June 1, 2001, is the period June 1, 2001, through December 31, 2001. Thus, if, based upon such testing period, A is a personal service corporation, A must obtain the Commissioner's permission to use a March 31 taxable year.

(d) *Performance of personal services*—(1) *Activities described in section 448(d)(2)(A)*. For purposes of this section, any activity of the taxpayer described in section 448(d)(2)(A) or the regulations thereunder will be treated as the performance of personal services. Therefore, any activity of the taxpayer that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (as such fields are defined in § 1.448–1T) will be treated as the performance of personal services for purposes of this section.

(2) *Activities not described in section 448(d)(2)(A)*. For purposes of this section, any activity of the taxpayer not described in section 448(d)(2)(A) or the regulations thereunder will not be treated as the performance of personal services.

(e) *Principal activity*—(1) *General rule*. For purposes of this section, the principal activity of a corporation for any testing period will be the performance of personal services if the cost of the corporation's compensation (the compensation cost) for such testing period that is attributable to its activities that are treated as the performance of personal services within the meaning of paragraph (d) of this section (*i.e.*, the total compensation for personal service activities) exceeds 50 percent of the corporation's total compensation cost for such testing period.

(2) *Compensation cost*—(i) *Amounts included*. For purposes of this section, the compensation cost of a corporation for a taxable year is equal to the sum of the following amounts allowable as a deduction, allocated to a long-term contract, or otherwise chargeable to a capital account by the corporation during such taxable year—

(A) Wages and salaries; and

(B) Any other amounts, attributable to services performed for or on behalf of the corporation by a person who is an employee of the corporation (including an owner of the corporation who is treated as an employee under paragraph (g)(2) of this section) during the testing period. Such amounts include, but are not limited to, amounts attributable to deferred compensation, commissions, bonuses, compensation includible in income under section 83, compensation for services based on a percentage of profits, and the cost of providing fringe benefits that are includible in income.

(ii) *Amounts excluded*. Notwithstanding paragraph (e)(2)(i) of this section, compensation cost does not include amounts attributable to a plan qualified under section 401(a) or 403(a), or to a simplified employee pension plan defined in section 408(k).

(3) *Attribution of compensation cost to personal service activity*—(i) *Employees involved only in the performance of personal services*. The compensation cost for employees involved only in the performance of activities that are treated as personal services under paragraph (d) of this section, or employees involved only in supporting the work of such employees, are considered to be attributable to the corporation's personal service activity.

(ii) *Employees involved only in activities that are not treated as the performance of personal services*. The compensation cost for employees involved only in the performance of activities that are not treated as personal services under paragraph (d) of this section, or for employees involved only in supporting the work of such employees, are not considered to be attributable to the corporation's personal service activity.

(iii) *Other employees*. The compensation cost for any employee who is not described in either paragraph (e)(3)(i) or (ii) of this section (a mixed-activity employee) is allocated as follows—

(A) *Compensation cost attributable to personal service activity*. That portion of the compensation cost for a mixed activity employee that is attributable to the corporation's personal service activity

equals the compensation cost for that employee multiplied by the percentage of the total time worked for the corporation by that employee during the year that is attributable to activities of the corporation that are treated as the performance of personal services under paragraph (d) of this section. That percentage is to be determined by the taxpayer in any reasonable and consistent manner. Time logs are not required unless maintained for other purposes;

(B) *Compensation cost not attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is not considered to be attributable to the corporation's personal service activity is the compensation cost for that employee less the amount determined in paragraph (e)(3)(iii)(A) of this section.

(f) *Services substantially performed by employee-owners*—(1) *General rule.* Personal services are substantially performed during the testing period by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost for that period attributable to its activities that are treated as the performance of personal services within the meaning of paragraph (d) of this section (*i.e.*, the total compensation for personal service activities) is attributable to personal services performed by employee-owners.

(2) *Compensation cost attributable to personal services.* For purposes of paragraph (f)(1) of this section—

(i) The corporation's compensation cost attributable to its activities that are treated as the performance of personal services is determined under paragraph (e)(3) of this section; and

(ii) The portion of the amount determined under paragraph (f)(2)(i) of this section that is attributable to personal services performed by employee-owners is to be determined by the taxpayer in any reasonable and consistent manner.

(3) *Examples.* The provisions of this paragraph (f) may be illustrated by the following examples:

Example 1. For its taxable year beginning February 1, 2001, Corp A's testing period is the taxable year ending January 31, 2000. During that testing period, A's only activity was the performance of personal services. The total compensation cost of A (including compensation cost attributable to employee-owners) for the testing period was $1,000,000. The total compensation cost attributable to employee-owners of A for the testing period was $210,000. Pursuant to paragraph (f)(1) of this section, the employee-owners of A substantially performed the personal services of A during the testing period because the compensation cost of A's employee-owners was more than 20 percent of the total compensation cost for all of A's employees (including employee-owners).

Example 2. Corp B has the same facts as corporation A in *Example 1*, except that during the taxable year ending January 31, 2001, B also participated in an activity that would not be characterized as the performance of personal services under this section. The total compensation cost of B (including compensation cost attributable to employee-owners) for the testing period was $1,500,000 ($1,000,000 attributable to B's personal service activity and $500,000 attributable to B's other activity). The total compensation cost attributable to employee-owners of B for the testing period was $250,000 ($210,000 attributable to B's personal service activity and $40,000 attributable to B's other activity). Pursuant to paragraph (f)(1) of this section, the employee-owners of B substantially performed the personal services of B during the testing period because more than 20 percent of B's compensation cost during the testing period attributable to its personal service activities was attributable to personal services performed by employee-owners ($210,000).

(g) *Employee-owner defined*—(1) *General rule.* For purposes of this section, a person is an employee-owner of a corporation for a testing period if—

(i) The person is an employee of the corporation on any day of the testing period; and

(ii) The person owns any outstanding stock of the corporation on any day of the testing period.

(2) *Special rule for independent contractors who are owners.* Any person who is an owner of the corporation within the meaning of paragraph (g)(1)(ii) of this section and who performs personal services for, or on behalf of, the corporation is treated as an employee for purposes of this section, even if the legal form of that person's relationship to the corporation is such that the person would be considered an independent contractor for other purposes.

(h) *Special rules for affiliated groups filing consolidated returns*—(1) *In general.* For purposes of applying this section to the members of an affiliated group of corporations filing a consolidated return for the taxable year—

(i) The members of the affiliated group are treated as a single corporation;

(ii) The employees of the members of the affiliated group are treated as employees of such single corporation; and

(iii) All of the stock of the members of the affiliated group that is not owned by any other member of the affiliated group is treated as the outstanding stock of that corporation.

(2) *Examples.* The provisions of this paragraph (h) may be illustrated by the following examples:

Example 1. The affiliated group AB, consisting of corporation A and its wholly owned subsidiary B, filed a consolidated Federal income tax return for the taxable year ending January 31, 2001, and AB is attempting to determine whether it is affected by this section for its taxable year beginning February 1, 2001. During the testing period (*i.e.*, the taxable year ending January 31, 2001), A did not perform personal services. However, B's only activity was the performance of personal services. On the last day of the testing period, employees of A did not own any stock in A. However, some of B's employees own stock in A. In the aggregate, B's employees own 9 percent of A's stock on the last day of the testing period. Pursuant to paragraph (h)(1) of this section, this section is effectively applied on a consolidated basis to members of an affiliated group filing a consolidated Federal income tax return. Because the only employee-owners of AB are the employees of B, and because B's employees do not own more than 10 percent of AB on the last day of the testing period, AB is not a PSC subject to the provisions of this section. Thus, AB is not required to determine on a consolidated basis whether, during the testing period, its principal activity is the providing of personal services, or the personal services are substantially performed by employee-owners.

Example 2. The facts are the same as in *Example 1*, except that on the last day of the testing period A owns only 80 percent of B. The remaining 20 percent of B is owned by employees of B. The fair market value of A, including its 80 percent interest in B, as of the last day of the testing period, is $1,000,000. In addition, the fair market value of the 20 percent interest in B owned by B's employees is $50,000 as of the last day of the testing period. Pursuant to paragraphs (c)(1)(iv) and (h)(1) of this section, AB must determine whether the employee-owners of A and B (*i.e.*, B's employees) own more than 10 percent of the fair market value of A and B as of the last day of the testing period. Because the $140,000 [($1,000,000 x .09) + $50,000] fair market value of the stock held by B's employees is greater than 10 percent of the aggregate fair market value of A and B as of the last day of the testing period, or $105,000 [$1,000,000 + $50,000 x .10], AB may be subject to this section if, on a consolidated basis during the testing period, the principal activity of AB is the performance of personal services and the personal services are substantially performed by employee-owners.

§ 1.441–4 Effective date.

Sections 1.441–0 through 1.441–3 are applicable for taxable years ending on or after May 17, 2002.

§§ 1.441–1T, 1.441–2T, 1.441–3T and 1.441–4T [Removed]

Par. 4. Sections 1.441–1T, 1.441–2T, 1.441–3T and 1.441–4T are removed.

Par 5. Section 1.442–1 is revised to read as follows:

§ 1.442–1 Change of annual accounting period.

(a) *Approval of the Commissioner.* A taxpayer that has adopted an annual accounting period (as defined in § 1.441–1(b)(3)) as its taxable year generally must continue to use that annual accounting period in computing its taxable income and for making its Federal income tax returns. If the taxpayer wants to change its annual accounting period and use a new taxable year, it must obtain the approval of the Commissioner, unless it is otherwise authorized to change without the approval of the Commissioner under either the Internal Revenue Code (*e.g.*, section 444 and section 859) or the regulations thereunder (*e.g.*, paragraph (c) of this section). In addition, as described in § 1.441–1(c) and (d), a partnership, S corporation, electing S corporation, or personal service corporation (PSC) generally is required to secure the approval of the Commissioner to adopt or retain an annual accounting period other than its required taxable year. The manner of obtaining approval from the Commissioner to adopt, change, or retain an annual accounting period is provided in paragraph (b) of this Section. However, special rules for obtaining approval may be provided in other sections.

(b) *Obtaining approval*—(1) *Time and manner for requesting approval.* In order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128, "*Application To Adopt, Change, or Retain a Tax Year*", with the Commissioner within such time and in such manner as is provided in administrative procedures published by the Commissioner.

(2) *General requirements for approval.* An adoption, change, or retention in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention. In determining whether a taxpayer has established a business purpose and which terms, conditions, and adjustments will be required, consideration will be given to all the facts and circumstances relating to the adoption, change, or retention, including the tax consequences resulting therefrom. Generally, the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's required taxable year (as defined in § 1.441–1(b)(2)), ownership taxable year, or natural business year. In the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners will not be treated as a business purpose.

(3) *Administrative procedures.* The Commissioner will prescribe administrative procedures under which a taxpayer may be permitted to adopt, change, or retain an annual accounting period. These administrative procedures will describe the business purpose requirements (including an ownership taxable year and a natural business year) and the terms, conditions, and adjustments necessary to obtain approval. Such terms, conditions, and adjustments may include adjustments necessary to neutralize the tax effects of a substantial distortion of income that would otherwise result from the requested annual accounting period including: a deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one taxable year to another; a similar deferral or shifting in the case of any other person, such as a beneficiary in an estate; the creation of a short period in which there is a substantial net operating loss, capital loss, or credit (including a general business credit); or the creation of a short period in which there is a substantial amount of income to offset an expiring net operating loss, capital loss, or credit. See, for example, Rev. Proc. 2002–39, 2002–22 I.R.B. 1046, procedures for obtaining the Commissioner's prior approval of an adoption, change, or retention in annual accounting period through application to the national office; Rev. Proc. 2002–37, 2002–22 I.R.B. 1030, automatic approval procedures for certain corporations; Rev. Proc. 2002–38, 2002–22 I.R.B. 1037, automatic approval procedures for partnerships, S corporations, electing S corporations, and PSCs; and Rev. Proc. 66–50, 1966–2 C.B. 1260, automatic approval procedures for individuals. For availability of Revenue Procedures and Notices, see § 601.601(d)(2) of this chapter.

(4) *Taxpayers to whom Section 441(g) applies.* If section 441(g) and § 1.441–1(b)(1)(iv) apply to a taxpayer, the adoption of a fiscal year is treated as a change in the taxpayer's annual accounting period under Section 442. Therefore, that fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. In addition to any other terms and conditions that may apply to such a change, the taxpayer must establish and maintain books that adequately and clearly reflect income for the short period involved in the change and for the fiscal year proposed.

(c) *Special rule for change of annual accounting period by subsidiary corporation.* A subsidiary corporation that is required to change its annual accounting period under § 1.1502–76, relating to the taxable year of members of an affiliated group that file a consolidated return, does not need to obtain the approval of the Commissioner or file an application on Form 1128 with respect to that change.

(d) *Special rule for newly married couples.* (1) A newly married husband or wife may obtain automatic approval under this paragraph (d) to change his or her annual accounting period in order to use the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of that spouse ending after the date of marriage. Such automatic approval will be granted only if the newly married husband or wife adopting the annual accounting period of the other spouse files a Federal income tax return for the short period required by that change on or before the 15th day of the 4th month following the close of the short period. See Section 443 and the regulations thereunder. If the due date for any such short-period return occurs before the date of marriage, the first taxable year of the other spouse ending after the date of marriage cannot be

adopted under this paragraph (d). The short-period return must contain a statement at the top of page one of the return that it is filed under the authority of this paragraph (d). The newly married husband or wife need not file Form 1128 with respect to a change described in this paragraph (d). For a change of annual accounting period by a husband or wife that does not qualify under this paragraph (d), see paragraph (b) of this section.

(2) The provisions of this paragraph (d) may be illustrated by the following example:

Example. H & W marry on September 25, 2001. H is on a fiscal year ending June 30, and W is on a calendar year. H wishes to change to a calendar year in order to file joint returns with W. W's first taxable year after marriage ends on December 31, 2001. H may not change to a calendar year for 2001 since, under this paragraph (d), he would have had to file a return for the short period from July 1 to December 31, 2000, by April 16, 2001. Since the date of marriage occurred subsequent to this due date, the return could not be filed under this paragraph (d). Therefore, H cannot change to a calendar year for 2001. However, H may change to a calendar year for 2002 by filing a return under this paragraph (d) by April 15, 2002, for the short period from July 1 to December 31, 2001. If H files such a return, H and W may file a joint return for calendar year 2002 (which is W's second taxable year ending after the date of marriage).

(e) *Effective date*. The rules of this Section are applicable for taxable years ending on or after May 17, 2002.

§§ 1.442–2T and 1.442–3T [Removed]

Par. 6. Sections 1.442–2T and 1.442–3T are removed.

Par. 7. Section 1.706–1 is amended by revising paragraphs (a) and (b) and adding paragraph (d) to read as follows:

§ 1.706–1 Taxable years of partner and partnership.

(a) *Year in which partnership income is includible*. (1) In computing taxable income for a taxable year, a partner is required to include the Partner's distributive share of partnership items set forth in section 702 and the regulations thereunder for any partnership taxable year ending within or with the partner's taxable year. A partner must also include in taxable income for a taxable year guaranteed payments under Section 707(c) that are deductible by the partnership under its method of accounting in the partnership taxable year ending within or with the Partner's taxable year.

(2) The rules of this paragraph (a)(1) may beillustrated by the following example:

Example. Partner A reports income using a calendar year, while the partnership of which A is a member reports its income using a fiscal year ending May 31. The partnership reports its income and deductions under the cash method of accounting. During the partnership taxable year ending May 31, 2002, the Partnership makes guaranteed payments of $120,000 to A for services and for the use of capital. Of this amount, $70,000 was paid to A between June 1 and December 31, 2001, and the remaining $50,000 was paid to A between January 1 and May 31, 2002. The entire $120,000 paid to A is includible in A's taxable income for the calendar year 2002 (together with A's distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 2002).

(3) If a Partner receives distributions under section 731 or sells or exchanges all or part of a partnership interest, any gain or loss arising therefrom does not constitute partnership income.

(b) *Taxable year*—(1) *Partnership treated as a taxpayer*. The taxable year of a partnership must be determined as though the partnership were a taxpayer.

(2) *Partnership's taxable year*—(i) *Required taxable year*. Except as provided in paragraph (b)(2)(ii) of this section, the taxable year of a partnership must be—

(A) The majority interest taxable year, as defined in section 706(b)(4);

(B) If there is no majority interest taxable year, the taxable year of all of the principal partners of the partnership, as defined in 706(b)(3) (the principal partners' taxable year); or

(C) If there is no majority interest taxable year or principal partners' taxable year, the taxable year that produces the least aggregate deferral of income as determined under paragraph (b)(3) of this section.

(ii) *Exceptions*. A partnership may have a taxable year other than its required taxable year if it makes an election under section 444, elects to use a 52–53-week taxable year that ends with reference to its required taxable year or a taxable year elected under section 444, or establishes a business purpose for such taxable year and obtains approval of the Commissioner under section 442.

(3) *Least aggregate deferral*—(i) *Taxable year that results in the least aggregate deferral of income*. The taxable year that results in the least aggregate deferral of income will be the taxable year of one or more of the partners in the partnership which will result in the least aggregate deferral of income to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in partnership profits for that year. The partner's taxable year that produces the lowest sum when compared to the other partner's taxable years is the taxable year that results in the least aggregate deferral of income to the partners. If the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, the partnership may select any one of those taxable years as its taxable year. However, if one of the qualifying taxable years is also the partnership's existing taxable year, the partnership must maintain its existing taxable year. The determination of the taxable year that results in the least aggregate deferral of income generally must be made as of the beginning of the partnership's current taxable year. The director, however, may determine that the first day of the current taxable year is not the appropriate testing day and require the use of some other day or period that will more accurately reflect the ownership of the partnership and thereby the actual aggregate deferral to the partners where the partners engage in a transaction that has as its principal purpose the avoidance of the principles of this section. Thus, for example the preceding sentence would apply where there is a transfer of an interest in the partnership that results in a temporary transfer of that interest principally for purposes of qualifying for a specific taxable year under the principles of this section. For purposes of this section, deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year.

(ii) *Determination of the taxable year of a partner or partnership that uses a 52–53-week taxable year*. For purposes of the calculation described in paragraph (b)(3)(i) of this section, the taxable year of a partner or partnership that uses a 52–53-week taxable year must be the same year determined under the rules of

section 441(f) and the regulations thereunder with respect to the inclusion of income by the partner or partnership.

(iii) *Special de minimis rule*. If the taxable year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current taxable year, the Partnership's current taxable year will be treated as the taxable year with the least aggregate deferral. Thus, the partnership will not be permitted to change its taxable year.

(iv) *Examples*. The principles of this section may be illustrated by the following examples:

Example 1. Partnership P is on a fiscal year ending June 30. Partner A reports income on the fiscal year ending June 30 and Partner B reports income on the fiscal year ending July 31. A and B each have a 50 percent interest in partnership profits. For its taxable year beginning July 1, 1987, the partnership will be required to retain its taxable year since the fiscal year ending June 30 results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 6/30	**Year End**	**Interest in Partnership Profits**	**Months of Deferral for 6/30 Year End**	**Interest x Deferral**
Partner A	6/30	.5	0	0
Partner B	7/31	.5	1	.5
Aggregate deferral				.5

Test 7/31	**Year End**	**Interest in Partnership Profits**	**Months of Deferral for 7/31 Year End**	**Interest x Deferral**
Partner A	6/30	.5	11	5.5
Partner B	7/31	.5	0	0
Aggregate deferral				5.5

Example 2. The facts are the same as in *Example 1* except that A reports income on the calendar year and B reports on the fiscal year ending November 30. For the partnership's taxable year beginning July 1, 1987, the partnership is required to change its taxable year to a fiscal year ending November 30 because such year results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 12/31	**Year End**	**Interest in Partnership Profits**	**Months of Deferral for 12/31 Year End**	**Interest x Deferral**
Partner A	12/31	.5	0	0
Partner B	11/30	.5	11	5.5
Aggregate deferral				5.5

Test 11/30	**Year End**	**Interest in Partnership Profits**	**Months of Deferral for 11/30 Year End**	**Interest x Deferral**
Partner A	12/31	.5	1	.5
Partner B	11/30	.5	0	0
Aggregate deferral				.5

Example 3. The facts are the same as in *Example 2* except that B reports income on the fiscal year ending June 30. For the partnership's taxable year beginning July 1, 1987, each partner's taxable year will result in identical aggregate deferral of income. If the partnership's current taxable year was neither a fiscal year ending June 30 nor the calendar year, the partnership would select either the fiscal year ending June 30 or the calendar year as its taxable year. However, since the partnership's current taxable year ends June 30, it must retain its current taxable year. The determination is made as follows:

Test 12/31	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A	12/31	.5	0	0
Partner B	6/30	.5	6	3.0
Aggregate deferral				3.0

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	12/31	.5	6	3.0
Partner B	6/30	.5	0	0
Aggregate deferral				3.0

Example 4. The facts are the same as in *Example 1* except that on December 31, 1987, partner A sells a 4 percent interest in the Partnership to Partner C, who reports income on the fiscal year ending June 30, and a 40 percent interest in the partnership to Partner D, who also reports income on the fiscal year ending June 30. The taxable year beginning July 1, 1987, is unaffected by the sale. However, for the taxable year beginning July 31, 1988, the partnership must determine the taxable year resulting in the least aggregate deferral as of July 1, 1988. In this case, the partnership will be required to retain its taxable year since the fiscal year ending June 30 continues to be the taxable year that results in the least aggregate deferral of income to the partners.

Example 5. The facts are the same as in *Example 4* except that Partner D reports income on the fiscal year ending April 30. As in *Example 4*, the taxable year during which the sale took place is unaffected by the shifts in interests. However, for its taxable year beginning July 1, 1988, the partnership will be required to change its taxable year to the fiscal year ending April 30. This determination is made as follows:

Test 7/31	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral
Partner A	6/30	.06	11	.66
Partner B	7/31	.5	0	0
Partner C	6/30	.04	11	.44
Partner D	4/30	.4	9	3.60
Aggregate deferral				4.70

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	6/30	.06	0	0
Partner B	7/31	.5	1	.5
Partner C	6/30	.04	0	0
Partner D	4/30	.4	10	4.0
				4.5
Aggregate deferral				

Test 4/30	Year End	Interest in Partnership Profits	Months of Deferral for 4/30 Year End	Interest x Deferral
Partner A	6/30	.06	2	.12
Partner B	7/31	.5	3	1.50
Partner C	6/30	.04	2	.08
Partner D	4/30	.4	0	0
Aggregate deferral				1.70

§ 1.706–1(b)(3) Test:	
Current taxable year (June 30)	4.5
Less: Taxable year producing the least aggregate deferral (April 30)	1.7
Additional aggregate deferral (greater than .5)	2.8

Example 6. (i) Partnership P has two partners, A who reports income on the fiscal year ending March 31, and B who reports income on the fiscal year ending July 31. A and B share profits equally. P has determined its taxable year under paragraph (b)(3) of this section to be the fiscal year ending March 31 as follows:

Test 3/31	Year End	Interest in Partnership Profits	Months of Deferral for 3/31 Year End	Interest x Deferral
Partner A	3/31	.5	0	0
Partner B	7/31	.5	4	2
Aggregate deferral				2

Test 7/31	Year End	Interest in Partnership Profits	Deferral for 7/31 Year End	Interest x Deferral
Partner A	3/31	.5	8	4
Partner B	7/31	.5	0	0
Aggregate deferral				4

(ii) In May 1988, Partner A sells a 45 percent interest in the partnership to C, who reports income on the fiscal year ending April 30. For the taxable period beginning April 1, 1989, the fiscal year ending April 30 is the taxable year that produces the least aggregate deferral of income to the partners. However, under paragraph (b)(3)(iii) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

Test 3/31	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral
Partner A	3/31	.05	0	0
Partner B	7/31	.5	4	2.0
Partner C	4/30	.45	1	.45
Aggregate deferral				2.45

Test 7/31	Year End	Interest in Partnership Profits	Deferral for 7/31 Year End	Interest Deferral
Partner A	3/31	.05	8	.40
Partner B	7/31	.5	0	0
Partner C	4/30	.45	9	4.05
Aggregate deferral				4.45

Test 4/30	Year End	Interest in Partnership Profits	Deferral for 4/30 Year End	Interest Deferral
Partner A	3/31	.05	11	.55
Partner B	7/31	.5	3	1.50
Partner C	4/30	.45	0	0
Aggregate deferral				2.05

§ 1.706–1(b)(3) Test:	
Current taxable year (3/31)	2.45
Less: Taxable year producing the leastaggregate deferral (4/30).	2.05
	.40
Additional aggregate deferral (greater than .5)	

(4) *Measurement of partner's profits and capital interest*— (i) *In general.* The rules of this paragraph (b)(4) apply in determining the majority interest taxable year, the principal partners' taxable year, and the least aggregate deferral taxable year.

(ii) *Profits interest*—(A) *In general.* For purposes of section 706(b), a partner's interest in partnership profits is generally the partner's percentage share of partnership profits for the current partnership taxable year. If the partnership does not expect to have net income for the current partnership taxable year, then a partner's interest in partnership profits instead must be the partner's percentage share of partnership net income for the first taxable year in which the partnership expects to have net income.

(B) *Percentage share of partnership net income.* The partner's percentage share of partnership net income for a partnership taxable year is the ratio of: the partner's distributive share of partnership net income for the taxable year, to the partnership's net income for the year. If a partner's percentage share of partnership net income for the taxable year depends on the amount or nature of partnership income for that year (due to, for example, preferred returns or special allocations of specific partnership items), then the partnership must make a reasonable estimate of the amount and nature of its income for the taxable year. This estimate must be based on all facts and circumstances known to the partnership as of the first day of the current partnership taxable year. The partnership must then use this estimate in determining the partners' interests in partnership profits for the taxable year.

(C) *Distributive share.* For purposes of this paragraph (b)(4)(ii), a partner's distributive share of partnership net income is determined by taking into account all rules and regulations affecting that determination, including, without limitation, sections 704(b), (c), and (e), 736, and 743.

(iii) *Capital interest.* Generally, a partner's interest in partnership capital is determined by reference to the assets of the partnership that the partner would be entitled to upon withdrawal from the partnership or upon liquidation of the partnership. If the partnership maintains capital accounts in accordance with § 1.704–1(b)(2)(iv), then for purposes of section 706(b), the partnership may assume that a partner's interest in partnership capital is the ratio of the partner's capital account to all partners' capital accounts as of the first day of the partnership taxable year.

(5) *Certain tax-exempt partners disregarded.* [Reserved]

(6) *Foreign Partners.* [Reserved]

(7) *Adoption of taxable year.* A newly-formed partnership may adopt, in accordance with § 1.441–1(c), its required taxable year, a taxable year elected under section 444, or a 52–53-week taxable year ending with reference to its required taxable year or a taxable year elected under section 444 without securing the approval of the Commissioner. If a newly-formed partnership wants to adopt any other taxable year, it must establish a business purpose and secure the approval of the Commissioner under section 442.

(8) *Change in taxable year*—(i) *Partnerships—(A) Approval required.* An existing partnership may change its taxable year only by securing the approval of the Commissioner under section 442 or making an election under Section 444. However, a partnership may obtain automatic approval for certain changes, including a change to its required taxable

year, pursuant to administrative procedures published by the Commissioner.

(B) *Short period tax return.* A partnership that changes its taxable year must make its return for a short period in accordance with section 443, but must not annualize the partnership taxable income.

(C) *Change in required taxable year.* If a partnership is required to change to its majority interest taxable year, then no further change in the partnership's required taxable year is required for either of the two years following the year of the change. This limitation against a second change within a three-year period applies only if the first change was to the majority interest taxable year and does not apply following a change in the partnership's taxable year to the principal partners' taxable year or the least aggregate deferral taxable year.

(ii) *Partners.* Except as otherwise provided in the Internal Revenue Code or the regulations thereunder (*e.g.*, section 859 regarding real estate investment trusts or § 1.442–2(c) regarding a subsidiary changing to its consolidated parent's taxable year), a partner may not change its taxable year without securing the approval of the Commissioner under section 442. However, certain partners may be eligible to obtain automatic approval to change their taxable years pursuant to the regulations or administrative procedures published by the Commissioner. A partner that changes its taxable year must make its return for a short period in accordance with section 443.

(9) *Retention of taxable year.* In certain cases, a partnership will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a partnership using a taxable year that corresponds to its required taxable year must obtain the approval of the Commissioner to retain such taxable year if its required taxable year changes as a result of a change in ownership, unless the partnership previously obtained approval for its current taxable year or, if appropriate, makes an election under section 444.

(10) *Procedures for obtaining approval or making a section 444 election.* See § 1.442–1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444–1T and 1.444–2T for qualifications, and § 1.444–3T for procedures, for making an election under section 444.

* * * * *

(d) *Effective date.* The rules of this section are applicable for taxable years ending on or after May 17, 2002, except for paragraph (c), which applies for taxable years beginning after December 31, 1953.

§ 1.706–1T [Removed]

Par. 8. Section 1.706–1T is removed.

Par. 9. Section 1.1378–1 is added under the undesignated centerheading "Small Business Corporations and Their Shareholders" to read as follows:

§ 1.1378–1 Taxable year of S corporation.

(a) *In general.* The taxable year of an S corporation must be a permitted year. A permitted year is the required taxable year (*i.e.*, a taxable year ending on December 31), a taxable year elected under section 444, a 52–53-week taxable year ending with reference to the required taxable year or a taxable year elected under section 444, or any other taxable year for which the corporation establishes a business purpose to the satisfaction of the Commissioner under section 442.

(b) *Adoption of taxable year.* An electing S corporation may adopt, in accordance with § 1.441–1(c), its required taxable year, a taxable year elected under section 444, or a 52–53-week taxable year ending with reference to its required taxable year or a taxable year elected under section 444 without the approval of the Commissioner. See § 1.441–1. An electing S corporation that wants to adopt any other taxable year, must establish a business purpose and obtain the approval of the Commissioner under section 442.

(c) *Change in taxable year*—(1) *Approval required.* An S corporation or electing S corporation that wants to change its taxable year must obtain the approval of the Commissioner under section 442 or make an election under section 444. However, an S corporation or electing S corporation may obtain automatic approval for certain changes, including a change to its required taxable year, pursuant to administrative procedures published by the Commissioner.

(2) *Short period tax return.* An S corporation or electing S corporation that changes its taxable year must make its return for a short period in accordance with section 443, but must not annualize the corporation's taxable income.

(d) *Retention of taxable year.* In certain cases, an S corporation or electing S corporation will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under Section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that elects to be an S corporation and, as a result, is required to use the calendar year must obtain the approval of the Commissioner to retain its current fiscal year.

(e) *Procedures for obtaining approval or making a section 444 election*—(1) *In general.* See § 1.442–1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

(2) *Special rules for electing S corporations.* An electing S corporation that wants to adopt, change to, or retain a taxable year other than its required taxable year must request approval of the Commissioner on Form 2553, *Election by a Small Business Corporation*, when the election to be an S corporation is filed pursuant to section 1362(b) and § 1.1362–6. See § 1.1362–6(a)(2)(i) for the manner of making an election to be an S corporation. If such corporation receives permission to adopt, change to, or retain a taxable year other than its required taxable year, the election to be an S corporation will be effective. Denial of the request renders the election ineffective unless the corporation agrees that, in the event the request to adopt, change to, or retain a taxable year other than its required taxable year is denied, it will adopt, change to, or retain its required taxable year or, if applicable, make an election under section 444.

(f) *Effective date.* The rules of this Section are applicable for taxable years ending on or after May 17, 2002.

PART 5c—TEMPORARY INCOME TAX REGULATIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981

Par. 10. The authority citation for part 5c continues to read as follows:

Authority 26 U.S.C. 168(f)(8)(G) and 7805.

§ 5c.442–1 [Removed]

Par. 11. Section 5c.442–1 is removed.

PART 5f—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

Par. 12. The authority citation for part 5f continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§ 5f.442–1 [Removed]

Par. 13. Section 5f.442–1 is removed.

PART 18—TEMPORARY INCOME TAX REGULATIONS UNDER THE SUBCHAPTER S REVISION ACT OF 1982

Par. 14. The authority citation for part 18 continues to read as follows:

Authority 26 U.S.C. 7805.

§ 18.1378–1T [Removed]

Par. 15. Section 18.1378–1 is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 16. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 17. In § 602.101, paragraph (b) is amended by adding an entry for "1.441–2", removing the entries for "1.441–3T", "1.442–2T", and "1.442–3T", revising the entry for "1.442–1", and adding an entry for "1.1378–1" in numerical order to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.441–2	1545–1748
* * * * *	
1.442–1	1545–0074 1545–0123 1545–0134 1545–0152 1545–1748
* * * * *	
1.1378–1	1545–1748
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved May 3, 2002.

Pamela F. Olson,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on May 16, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 17, 2002, 67 F.R. 35009)

Section 442.—Change of Annual Accounting Period

26 CFR 1.442–1: Change of annual accounting period.

Final regulations relate to obtaining approval of the Commissioner to adopt, change, or retain an annual accounting period under section 442 of the Code. See T.D. 8996, page 1127.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 472.—Last-in, First-out Inventories

26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The April 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, April 30, 2002.

Rev. Rul. 2002–37

The following Department Store Inventory Price Indexes for April 2002 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, April 30, 2002.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Apr. 2001	Apr. 2002	Percent Change from Apr. 2001 to Apr. 2002[1]
1. Piece Goods	497.9	488.7	-1.8
2. Domestics and Draperies	606.5	597.7	-1.5
3. Women's and Children's Shoes	657.4	652.6	-0.7
4. Men's Shoes	895.3	902.7	0.8
5. Infants' Wear	626.8	622.2	-0.7
6. Women's Underwear	565.5	554.0	-2.0
7. Women's Hosiery	344.8	356.0	3.2
8. Women's and Girls' Accessories	557.3	565.6	1.5
9. Women's Outerwear and Girls' Wear	414.5	395.0	-4.7
10. Men's Clothing	591.8	600.2	1.4
11. Men's Furnishings	618.7	604.4	-2.3
12. Boys' Clothing and Furnishings	485.0	504.2	4.0
13. Jewelry	938.6	905.6	-3.5
14. Notions	793.4	794.8	0.2
15. Toilet Articles and Drugs	991.0	974.7	-1.6
16. Furniture and Bedding	650.3	627.7	-3.5
17. Floor Coverings	626.8	618.7	-1.3
18. Housewares	773.8	756.6	-2.2
19. Major Appliances	224.8	222.6	-1.0
20. Radio and Television	55.2	50.8	-8.0
21. Recreation and Education[2]	90.3	87.2	-3.4
22. Home Improvements[2]	127.0	125.8	-0.9
23. Auto Accessories[2]	109.0	110.8	1.7
Groups 1 — 15: Soft Goods	603.2	591.9	-1.9
Groups 16 — 20: Durable Goods	426.5	413.9	-3.0
Groups 21 — 23: Misc. Goods[2]	98.9	97.1	-1.8
Store Total[3]	537.5	526.3	-2.1

[1] Absence of a minus sign before the percentage change in this column signifies a price increase.
[2] Indexes on a January 1986=100 base.
[3] The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622–7718 (not a toll-free call).

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 706.—Taxable Years of Partner and Partnership

26 CFR 1.706–1: Taxable years of partner and partnership.

Final regulations relate to taxable years of partnerships under section 706 of the Code. See T.D. 8996, page 1127.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for June 2002.

Rev. Rul. 2002–36

This revenue ruling provides various prescribed rates for federal income tax purposes for June 2002 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2002–36 TABLE 1

Applicable Federal Rates (AFR) for June 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	2.91%	2.89%	2.88%	2.87%
110% AFR	3.21%	3.18%	3.17%	3.16%
120% AFR	3.50%	3.47%	3.46%	3.45%
130% AFR	3.80%	3.76%	3.74%	3.73%
Mid-Term				
AFR	4.74%	4.69%	4.66%	4.64%
110% AFR	5.23%	5.16%	5.13%	5.11%
120% AFR	5.71%	5.63%	5.59%	5.57%
130% AFR	6.19%	6.10%	6.05%	6.02%
150% AFR	7.16%	7.04%	6.98%	6.94%
175% AFR	8.38%	8.21%	8.13%	8.07%

REV. RUL. 2002–36 TABLE 1—CONTINUED

Applicable Federal Rates (AFR) for June 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Long-Term				
AFR	5.70%	5.62%	5.58%	5.56%
110% AFR	6.28%	6.18%	6.13%	6.10%
120% AFR	6.85%	6.74%	6.68%	6.65%
130% AFR	7.44%	7.31%	7.24%	7.20%

REV. RUL. 2002–36 TABLE 2

Adjusted AFR for June 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	2.45%	2.44%	2.43%	2.43%
Mid-term adjusted AFR	3.67%	3.64%	3.62%	3.61%
Long-term adjusted AFR	4.89%	4.83%	4.80%	4.78%

REV. RUL. 2002–36 TABLE 3

Rates Under Section 382 for June 2002

Adjusted federal long-term rate for the current month	4.89%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.01%

REV. RUL. 2002–36 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for June 2002

Appropriate percentage for the 70% present value low-income housing credit	8.22%
Appropriate percentage for the 30% present value low-income housing credit	3.52%

REV. RUL. 2002–36 TABLE 5	
Rate Under Section 7520 for June 2002	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.8%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 1378.—Taxable Year of S Corporation

26 CFR 1.1378–1: Taxable year of S corporation.

Final regulations relate to taxable years of S corporations under section 1378 of the Code. See T.D. 8996, page 1127.

Section 4261.—Imposition of Tax

26 CFR 49.4261–1: Imposition of tax; in general. (Also §§ 4281.)

Segment Tax. This ruling provides guidance on how to calculate the tax on domestic segments under section 4261(b) of the Code if an aircraft is chartered and one or more persons are transported on that aircraft.

Rev. Rul. 2002–34

ISSUE

How is the tax on domestic segments under § 4261(b) of the Internal Revenue Code calculated if an aircraft is chartered and one or more persons are transported on that aircraft?

FACTS

X operates an air charter service that provides taxable air transportation. Each of *X*'s aircraft has a certificated takeoff weight in excess of 6,000 pounds. The amount *X* charges for the charter of an aircraft is not affected by the number of passengers transported on the aircraft. Passengers transported on the aircraft do not pay for the transportation.

LAW AND ANALYSIS

Section 4261(a) imposes a tax on the amount paid for taxable transportation (as defined in § 4262) of any person by air (the percentage tax) equal to 7.5 percent of the amount paid.

Section 4262(a)(1) provides that the term "taxable transportation" includes transportation by air which begins in the United States and ends in the United States.

Section 4261(b)(1), enacted by § 1031(c)(1) of the Taxpayer Relief Act of 1997, 1997–4 (Vol. 1) C.B. 1, 143, imposes a tax on the amount paid for each domestic segment of taxable transportation (the segment tax) equal to a fixed amount determined in accordance with the table contained in that section. For segments beginning in 2002, that amount is $3.00 per segment. The term "domestic segment" is defined in § 4261(b)(2) as any segment consisting of one takeoff and one landing that is taxable transportation described in § 4262(a)(1).

Section 4261(c) imposes a tax on any amount paid for any transportation of any person by air if the transportation begins or ends in the United States (the international facilities tax). Generally, the amount of the tax was set at $12.00 for amounts paid in 1997. Section 4261(e)(4) provides that the amount of the tax imposed by § 4261(c) is to be adjusted for inflation; generally, the amount of the tax for amounts paid in 2002 is $13.20.

Section 4281 provides an exemption from the tax imposed by § 4261 for aircraft having a certificated takeoff weight of 6,000 pounds or less, except when that aircraft is operated on an established line.

Rev. Rul. 72–309, 1972–1 C.B. 348, addresses the calculation of the international facilities tax imposed by § 4261(c) in the context of a single payment for a charter. The revenue ruling concludes that, if a single amount is paid for a charter, the § 4261(c) international facilities tax applies with respect to each passenger because implicit in the charter fee is an amount paid for the transportation of each passenger actually on the flight.

The § 4261(b) segment tax is similar to the § 4261(c) international facilities tax inasmuch as it is not calculated as a percentage of the amount paid, but is a fixed amount imposed on the amount paid for the transportation. Rev. Rul. 72–309 establishes that implicit in a charter payment is an amount paid for each passenger actually on the flight. Thus, as in the case of the § 4261(c) international facilities tax, the § 4261(b) segment tax is to be calculated on a per-passenger basis. Accordingly, for each segment, *X* must calculate the § 4261(b) segment tax by multiplying the amount of tax set forth in § 4261(b)(1) by the number of passengers transported on the chartered aircraft. (The segment tax so determined is not an amount paid for taxable transportation for purposes of calculating the § 4261(a) percentage tax.)

HOLDING

If an aircraft is chartered and one or more persons are transported on that aircraft, for each segment the tax under § 4261(b) is calculated by multiplying the amount of tax set forth in § 4261(b)(1) by the number of passengers transported on the aircraft.

DRAFTING INFORMATION

The principal author of this revenue ruling is Patrick S. Kirwan of the Office of Associate Chief Counsel (Passthroughs

and Special Industries). For further information regarding this revenue ruling, contact Mr. Kirwan at (202) 622–3130 (not a toll-free call).

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of June 2002. See Rev. Rul. 2002–36, page 1148.

Additional Relief for Certain Taxpayers Affected by the September 11, 2001 Terrorist Attack

Notice 2002–40

PURPOSE

This notice supplements and expands the relief granted under section 7508A of the Internal Revenue Code (Code) in Notice 2001–61, 2001–40 I.R.B. 305, and Notice 2001–68, 2001–47 I.R.B. 504, for taxpayers affected by the September 11, 2001, Terrorist Attack. In Notice 2001–61 and Notice 2001–68, the Department of the Treasury and the IRS extended and postponed filing and payment due dates for affected taxpayers. At the time those notices were issued, the Code limited the amount of interest relief the IRS could provide to an affected taxpayer. Under section 6404(h), interest was abated only for income taxes due from an affected taxpayer located in the Presidentially declared disaster area and only if both an extension of time to file under section 6081 and an extension of time to pay under section 6161 were granted to the taxpayer. The Secretary's authority to provide relief under section 7508A was specifically limited to items other than interest. In addition, section 7508A permitted the Secretary to disregard no more than 120 days in the calculation of penalties.

On January 23, 2002, the President signed into law the Victims of Terrorism Tax Relief Act of 2001 (the Act). Section 112 of the Act repealed section 6404(h) and amended section 7508A (effective September 11, 2001), by providing, in part, that the Secretary may disregard up to one year in determining the amount of any interest or penalty. Under this increased authority, the Department of the Treasury and the IRS are providing relief from interest and expanded relief from the failure to pay penalty for certain affected taxpayers.

GRANT OF RELIEF

(1) For affected taxpayers with an original income tax return due date on or after September 11, 2001, and on or before November 30, 2001, that were previously granted a six-month extension of time to file and pay and a 120 day postponement of time to file and pay by paragraphs (1) and (2) of the Grant of Relief Section of Notice 2001–61, and for certain taxpayers who had difficulty in filing their federal income tax returns due on or after September 11, 2001, and on or before October 31, 2001, because of disruptions in the transportation and delivery of documents by mail or private delivery services resulting from the terrorist attack, that were previously granted a postponement of time to file and pay until November 15, 2001, by paragraph (5) of the Grant of Relief Section of Notice 2001–61, interest will not be due for the period of time that the payment is extended and postponed. For example, an affected fiscal year taxpayer with an original due date of September 17, 2001, has until July 15, 2002, to file and pay as a result of the relief granted by Notice 2001–61. Under this notice, no interest will accrue from September 17, 2001, through July 15, 2002. Additionally, no failure to file or pay penalty will accrue from September 17, 2001, through July 15, 2002. This relief applies to all affected taxpayers (as defined in Notice 2001–61 and Announcement 2001–124 2001–52 I.R.B. 630) no matter where they are located.

(2) For affected taxpayers with an extended income tax return due date on or after September 11, 2001, and on or before November 30, 2001, that were previously granted a 120 day postponement of time to file by Notice 2001–61, and for taxpayers with an extended due date on or after December 1, 2001, and on or before January 31, 2002, that were previously granted a postponement of time to file until February 15, 2002, by paragraph (1) of the Additional Grant of Relief section of Notice 2001–68, interest will not be due for the period beginning September 11, 2001, and ending with the postponed due date of the return. In addition, the relief from the failure to pay penalty provided by Notice 2001–61 for the period September 11, 2001, through January 9, 2002 (120 days) is expanded to cover the period beginning September 11, 2001, and ending with the postponed due date of the return. For example, an individual income taxpayer with an extended due date of October 15, 2001, has a postponed filing due date of February 12, 2002, as a result of the relief granted by Notice 2001–61. Under this notice, no interest or failure to pay penalty will accrue from September 11, 2001, through February 12, 2002, on any balance originally due on April 16, 2001. Interest and the failure to pay penalty will be owed on any balance due for the period April 16, 2001, through September 10, 2001, and on any balance remaining due after February 12, 2002.

(3) Under paragraph (6) of the Grant of Relief section of Notice 2001–61, certain taxpayers were granted a reasonable cause waiver from the failure to deposit penalty if third quarter tax deposits due from September 11, 2001, through September 30, 2001, were deposited by November 15, 2001. For these taxpayers, the third quarter return and payment were generally due on October 31, 2001. In the absence of relief under section 7508A (as amended), interest would be imposed for the period from November 1, 2001, through November 15, 2001, on any balance due on October 31, 2001. Under this notice, taxpayers will not owe interest for this period on any employment and excise tax liability for which the failure to deposit penalty has been waived.

(4) The IRS may have already assessed interest and penalties relieved under this notice and taxpayers may have already paid these amounts. The IRS has identified taxpayers located in the covered disaster area specified in Notice 2001–61 who are eligible for the additional relief and have adjusted those accounts accordingly. If you were located in the covered disaster area and are entitled to receive a refund, you should receive a notice by May 28, 2002. Taxpayers not located in the covered disaster area who are entitled to this additional relief (or anyone else with any questions regarding the status of an adjustment or

refund because of this notice), should contact the IRS at (866) 562–5227 (a toll-free call).

DRAFTING INFORMATION

This notice was authored by the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). For further information regarding this notice, you may call (202) 622–4940 (not a toll-free call).

Application Procedures for Withholding Foreign Partnership or Withholding Foreign Trust Status Under Section 1441; Proposed Withholding Foreign Partnership and Withholding Foreign Trust Agreements

Notice 2002–41

SECTION 1. PURPOSE

.01 *Proposed Guidance to Simplify Partnership and Trust Withholding and Reporting Obligations.* This notice contains proposed guidance for entering into a withholding foreign partnership (WP) or withholding foreign trust (WT) agreement with the Internal Revenue Service (IRS). Similar to the qualified intermediary (QI) withholding agreement,[1] the proposed WP and WT agreements are designed to simplify withholding and reporting obligations for payments of income made to partners of a WP and beneficiaries or owners of a WT. The IRS recognizes that foreign partnerships and trusts differ significantly from each other, as well as from foreign financial institutions that receive amounts subject to withholding as intermediaries for account holders. These proposed agreements attempt to address the unique features of partnerships and trusts by adopting tailored procedures for documentation, reporting and audit that facilitate compliance and reduce administrative and audit cost for the WP or WT. As discussed further in Section 7 of this notice, Treasury and the IRS request comments on these proposed agreements. Treasury and the IRS will review any comments received and intend thereafter to publish a revenue procedure containing the final text of the WP and WT agreements.

Under applicable Treasury regulations, a foreign partnership or foreign simple or grantor trust that is not a WP or WT is required to provide each withholding agent from whom it receives an amount subject to withholding under sections 1441 and 1442 of the Internal Revenue Code (Code) and the regulations thereunder with a Form W-8IMY, along with documentation from each of its partners, beneficiaries, or owners, and a withholding statement allocating the amount attributable to each partner, beneficiary, or owner. The withholding agent is required to withhold tax from payments to the partnership or trust and to report on Forms 1042-S and 1099 payments to, and tax withheld from, each partner, beneficiary, or owner.

Under the provisions of the WP and WT agreements, a WP or WT is permitted to provide the withholding agent with a Form W-8IMY as a WP or WT without attached documentation from partners, beneficiaries, or owners. The WP or WT receives payments from the withholding agent in gross and withholds and deposits tax, if any, based on the Forms W-8 or W-9 that it receives from its partners, beneficiaries, or owners. The WP or WT reports payments to, and tax withheld from, its direct foreign partners, beneficiaries or owners on Form 1042-S on an individual basis or, by election, on a pooled basis. Thus, a WP or WT is relieved of the requirement to disclose to a withholding agent any documentation and payment information for partners, beneficiaries or owners. A withholding agent is relieved of the responsibility for collecting documentation, withholding and reporting payment information for partners, beneficiaries and owners of a WP or WT.

.02 *Key Provisions.* The following key provisions, explained in greater detail in Section 4.02, are intended to work together to produce a simple and administrable agreement for withholding foreign partnerships and trusts.

Direct partners, beneficiaries or owners. A foreign partnership or simple or grantor trust that has entered into a WP or WT agreement may act as a WP or WT only with respect to amounts subject to NRA withholding that are distributed to, or included in the distributive share of, direct partners, beneficiaries, or owners. WP or WT must act as a nonwithholding foreign partnership or trust with respect to partners, beneficiaries, or owners that hold through intermediaries or passthrough entities. The foreign partnership or foreign simple or grantor trust may, however, act as a WP or WT with respect to amounts distributed to, or included in the distributive share of, another WP or WT.

Forms W-8 and W-9. WP or WT is required to document each direct partner, beneficiary or owner with Form W-8 or W-9.

Withholding and reporting—direct foreign partners, beneficiaries or owners. WP or WT is required to withhold and deposit tax, to file a tax return on Form 1042, and, absent a pooled reporting election, to report on Form 1042-S for each direct foreign partner, beneficiary or owner.

Reporting—pooled reporting election. WP or WT may elect to report on Form 1042-S on a pooled basis (using the recipient codes for QI pooling until such time that there are recipient codes for WPs and WTs that make an election to report on a pooled basis). Whether WP or WT elects pooled reporting will affect both the timing of audits and the term of the agreement.

Reporting—direct U.S. partners, beneficiaries or owners. WP or WT is not required to report on Form 1099 for U.S. partners, beneficiaries, or owners. However, if WP has U.S. partners, WP generally is required to file Form 1065 with Schedules K-1 for each U.S. partner. If WT is a grantor trust with U.S. owners, WT is required to file Form 3520-A and

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[1] See Rev. Proc. 2000–12, 2000–1 C.B. 387.

to provide statements to each U.S. beneficiary or owner. If WT makes a distribution to a U.S. person, WT must provide an information statement to that U.S. person pursuant to section 6048(c) of the Code.

Audit. Unless WP or WT has elected to report on Form 1042-S on a pooled basis, it will be subject to audit only if selected for audit by the IRS. In that case, WP or WT will be subject to audit by an external auditor unless WP or WT requests an IRS audit. If WP or WT elects pooled reporting it must agree to have the external auditor conduct an audit after the close of every other calendar year, which will examine the two previous calendar years.

Term of the agreement. The WP or WT agreement will continue in force indefinitely unless WP or WT has elected to report on Form 1042-S on a pooled basis. In that case, the agreement will expire after a term of six years.

Automatic termination. If WP or WT fails to document any partner, beneficiary or owner with Form W-8 or W-9 by the time withholding is required under the agreement, then, unless WP or WT cures its failure, the agreement will automatically terminate effective December 31st of the year in which the failure is discovered.

SECTION 2. SCOPE

.01 *Foreign Partnerships and Foreign Simple and Grantor Trusts.* This Notice applies to a foreign partnership seeking to qualify as a withholding foreign partnership under Treas. Reg. §1.1441–5(c)(2)(ii).[2] The proposed withholding foreign partnership agreement applies to amounts subject to NRA withholding that the partnership distributes to, or includes in the distributive shares of, its direct partners.

This Notice also applies to a foreign trust seeking to qualify as a withholding foreign trust under Treas. Reg. §1.1441–5(e)(5)(v). The proposed withholding foreign trust agreement applies to amounts subject to NRA withholding that are required to be distributed to the beneficiaries of a simple trust or that are includable in the income of the owners of a grantor trust ("distributive shares" of beneficiaries or owners).

The IRS intends that the WP and WT agreements will be available in all circumstances in which a foreign entity acting on behalf of its partners, beneficiaries or owners provides Form W-8IMY as proper documentation. For example, a WP or WT agreement would be available for an entity that is properly claiming treaty benefits for its owners under section 894 of the Code (notwithstanding that the entity may be treated as a corporation for U.S. tax purposes).

This Notice does not apply to intermediaries seeking to become QIs. Instead, see Rev. Proc. 2000–12, 2000–1 C.B. 387. The QI agreement applies to amounts subject to NRA withholding that are collected by an intermediary and paid to its account holders.

The QI agreement is not available to foreign partnerships or foreign trusts. As outlined below, the relationship of an intermediary and its account holders addressed in the QI agreement differs fundamentally from the relationship of a partnership and its partners and the relationship of a trust and its beneficiaries or owners.

.02 *Notice 2001–4.* Pending the development of these agreements, Notice 2001–4, 2001–1 C.B. 267, provided a transition rule for foreign partnerships for calendar year 2001. Under the transition rule, for calendar year 2001, partnerships were permitted to provide to withholding agents Form W-8IMY with partner documentation attached together with a withholding statement that furnished payment information on the basis of withholding rate pools. Because that relief is unavailable for payments after December 31, 2001, the IRS intends that subscribing partnerships will apply the WP agreement for calendar years after 2001.

Notice 2001–4 also permitted a QI to treat the beneficiaries of a foreign simple trust or the owners of a foreign grantor trust as direct account holders for purposes of the QI agreement if certain criteria were met. This rule will continue in effect after the WT agreement becomes available. Alternatively, foreign simple and grantor trusts, including those that meet the criteria set forth in Notice 2001–4, may choose to enter a WT agreement when the WT agreement is finalized.

SECTION 3. BACKGROUND

.01 *Withholding and Reporting on Payments to Foreign Persons.* Under sections 1441 and 1442 of the Internal Revenue Code (Code), a person that makes a payment of U.S. source interest, dividends, royalties, and certain other types of income to a foreign person generally must deduct and withhold 30 percent from the payment. A lower rate of withholding may apply under the Code (*e.g.*, section 1443), the regulations, or an income tax treaty. Generally, a payor of these types of income also must report the payments on Forms 1042-S. See Treas. Reg. § 1.1461–1(c).

Under sections 6041, 6042, 6045, 6049, and 6050N of the Code (the Form 1099 reporting provisions), payors of interest, dividends, royalties, gross proceeds from the sale of securities, and other fixed or determinable income must report payments on Form 1099 unless an exception applies. If a payment is reportable on Form 1099, a payor must generally obtain a Form W-9 from the payee. If the payor does not receive the Form W-9, it generally must backup withhold under section 3406 of the Code and report the payment on Form 1099.

An exception to the Form 1099 reporting provisions applies if the payee is a foreign person. A payor can treat a person as foreign if the payor can reliably associate the payment with a Form W-8 or other documentation that establishes that the person is the foreign beneficial owner of the income or a foreign payee. See Treas. Reg. §§ 1.1441–1, 1.6041–4(a), 1.6042–3(b)(1)(iii), 1.6045–1(g)(1)(i), 1.6049–5(b)(12), and 1.6050N–1(c)(1)(i). Moreover, a payor does not backup withhold on payments to foreign beneficial owners or foreign payees because backup withholding applies only to amounts that the payor must report on Form 1099.

[2] All citations to income tax regulations in this revenue procedure are to the regulations as amended by T.D. 8734, 1997–2 C.B. 109 [62 FR 53387], T.D. 8804, 1999–1 C.B. 793 [63 FR 72183], and T.D. 8856, 2000–1 C.B. 298 [64 FR 73408].

In general, the beneficial owners or payees of a payment to a person that is treated as a nonwithholding foreign partnership are the partners (looking through partners that are foreign intermediaries or flow-through entities). However, a payment to a withholding foreign partnership is treated as a payment to the partnership and not to the partners. See Treas. Reg. § 1.1441–5(c). Similarly, the beneficial owners of a payment to a nonwithholding foreign simple or grantor trust are the beneficiaries or owners of the trust (looking through beneficiaries or owners that are foreign intermediaries or flow-through entities). However, a payment to a withholding foreign trust is treated as a payment to the trust and not to its beneficiaries or owners. See Treas. Reg. § 1.1441–5(e).

A nonwithholding foreign partnership or nonwithholding foreign simple or grantor trust must forward documentation for each of its partners, beneficiaries or owners to each withholding agent making a payment to the partnership or trust so that the withholding agent can correctly withhold and report on Forms 1042-S and 1099, as appropriate. If a withholding agent does not receive that documentation, the withholding agent generally will withhold and report based on presumptions provided in the regulations. See Treas. Reg. §§ 1.1441–1, 1.1441–5 and 1.6049–5.

A foreign partnership or foreign trust is a withholding agent under sections 1441 and 1442 of the Code for amounts subject to withholding that it pays to foreign persons, including partners, beneficiaries and owners, and therefore must file Forms 1042 and 1042-S in the same manner as a U.S. withholding agent. However, a foreign partnership or foreign trust is not required to file Forms 1042 and 1042-S if another withholding agent has reported the same amount to the same recipient for which the foreign partnership or foreign trust would be required to file a return and the proper amount has been withheld. See Treas. Reg. § 1.1461–1(b) and (c)(4).

Under section 6031 of the Code, a foreign partnership that has gross income that is effectively connected with the conduct of a trade or business within the United States (ECI) is required to file a partnership return on Form 1065 with Schedules K-1 (*Statement of Partner's Share of Income, Credit, Deduction, Etc.*) for each partner. Also, a foreign partnership that has U.S. source gross income that is not ECI and that has U.S. partners is generally required to file Form 1065 and Schedules K-1 for each of its direct U.S. partners and for its passthrough partners through which U.S. partners hold an interest in the foreign partnership. See Treas. Reg. § 1.6031(a)–1(b). A foreign trust generally is not engaged in any trade or business. However, if it has gross income that is treated as effectively connected with the conduct of a U.S. trade or business, it must file a return on Form 1040NR. Under section 6048(b), a foreign trust that has a U.S. owner must file Form 3520-A, *Annual Information Return of a Foreign Trust with a U.S. Owner*. Under section 6048(c), a U.S. person that receives a distribution from a foreign trust must file Form 3520. The trust must provide an information statement to the U.S. distributee. See Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*.

SECTION 4. OVERVIEW OF PROPOSED AGREEMENTS

.01 *Comparison with QI Agreement*. The IRS recognizes that foreign partnerships and foreign simple and grantor trusts differ significantly from each other as well as from foreign financial institutions that act as intermediaries for their account holders. For instance, foreign partnerships and trusts generally (1) have unique governing provisions and allocations, (2) are not subject to any extensive government regulation and oversight (including know-your-customer laws), and (3) do not have staffing and systems comparable to financial institutions that are intermediaries. Thus, certain provisions in the QI agreement become problematic in the context of foreign partnerships and trusts, such as: the treatment of indirect account holders, collection and examination of documentary evidence, application of the presumption rules, and Form 1099 reporting. In addition, such entities often have special allocations that generally are not an issue with account holders of financial institutions.

.02 *Simplified Requirements and Procedures*. The proposed agreements attempt to minimize the difficulties unique to partnerships and trusts by adopting procedures that reduce the administrative and audit cost for the WP and WT, as well as the risk of error in performing under the agreements.

(i) *Limitation to direct partners, beneficiaries, or owners*. The WP and WT agreements apply only to payments from a WP or WT to its direct partners, beneficiaries, or owners. This limitation eliminates the need (1) for the WP or WT to apply the presumption rules on payments it makes to indirect partners, beneficiaries, or owners who failed to provide adequate documentation; (2) for the WP or WT to gather and review documentation and withholding information for indirect partners, beneficiaries, and owners; and (3) for the WP or WT to bear the expense of having an auditor review such documentation and withholding information for indirect partners. The presumption rules generally require a withholding agent to withhold at the highest rate, which often requires subsequent reimbursements or refunds, and also results in duplicative reporting. A WP or WT, nevertheless, may act as a WP or WT for payments it makes to a partner, beneficiary, or owner that is, itself, a WP or WT because, for payments to such entities, it is never necessary to apply the presumption rules, or review documentation for the partners, beneficiaries, or owners of such entities. Because the IRS and Treasury expect that many foreign partnerships and trusts will enter into WP and WT agreements with the IRS, it is expected that the number of WPs and WTs that have partners, beneficiaries, or owners that are nonwithholding foreign partnerships and nonwithholding foreign trusts will be relatively small.

(ii) *Documentation*. The agreements require a WT and WP to obtain Forms W-8 and W-9 from its direct partners, beneficiaries, or owners. Obtaining documentary evidence in lieu of Forms W-8 and W-9 is not permitted. Although this requirement is imposed primarily for simplicity, it is also necessary because a WP or WT generally is not subject to the know-your-customer (KYC) rules in its jurisdiction. Therefore, the IRS is unable

to rely on the regulators in that jurisdiction to ensure that a WP or WT is properly documenting its partners, beneficiaries, or owners. The IRS believes that this requirement should not unduly burden a WP or WT because, unlike a QI, which may have had large percentages of its account base already documented with KYC-type documentation for other regulatory purposes, a WP or WT generally will not.

(iii) *Automatic termination*. The agreements provide that, if on audit the IRS or external auditor discovers that the WP or WT was not in possession of a valid Form W-8 or W-9, as applicable, for any direct partner, beneficiary, or owner, the agreement will automatically terminate unless cured. This provision operates in conjunction with the documentation provisions described above to eliminate completely the application of the presumption rules by WP or WT. The extended date for withholding on undistributed income under the WP or WT agreements, as noted below, provides the WP or WT with more time to obtain documentation. Thus, it is expected that WP or WT will have ample time to comply with the documentation requirements to avoid automatic termination.

(iv) *Withholding*. Because information regarding special allocations among partners, beneficiaries, or owners often is unavailable at the time withholding is required, a WP or WT may find it difficult to determine the correct amount of withholding at the time a payment is received by WP or WT. To address this concern, the agreements provide that, where an actual distribution has not been made, a WP or WT is not required to withhold until the earlier of the date that the statements required under section 6031 (for partnerships) or section 6048 (for simple and grantor trusts) are mailed or otherwise provided to the partner, beneficiary or owner, or the due date for furnishing such statements (whether or not WP or WT is required to prepare and furnish such statements). With this delay in the time for withholding on undistributed income, the foreign partnership or trust who enters into the WP or WT agreement should be able to withhold accurately, thereby avoiding the need to correct withholding errors. This provision also will ease the audit burden by eliminating the need for the auditor to review numerous setoffs or reimbursements.

(v) *Pooled reporting*. Under the regulations, a foreign partnership or trust is required to provide the U.S. withholding agent with sufficient information so that it can properly report on Form 1042-S for each foreign partner, beneficiary, or owner. Under the agreements, the WP or WT assumes the Form 1042-S reporting requirement for each direct foreign partner, beneficiary, or owner. The IRS understands, however, that reporting on a beneficial owner basis is a concern for some foreign partnerships and trusts. To accommodate this concern, the agreements allow a WP or WT to elect pooled-basis reporting for those amounts distributed to, or includible in the income of, its direct foreign partners, beneficiaries, or owners. If a WP or WT makes the pooled reporting election, the term of the agreement will be limited and the WP or WT will be subject to external audit every other year.

(vi) *Elimination of Form 1099 reporting*. To avoid duplication of reporting to a WP's or WT's direct U.S. partners, beneficiaries, or owners, (*e.g.*, a Form 1099 and K-1 issued to the same U.S. partner of a foreign partnership for the same income), the agreements eliminate the requirement that a WP or WT file Form(s) 1099 for its direct U.S. partners, beneficiaries, or owners. The WP or WT must file the necessary forms, schedules, and statements required by sections 6031 and 6048, as applicable.

(vii) *Amendment and Termination of Agreement*. The agreements may be amended by the IRS if the IRS determines that such amendment is needed for the sound administration of the applicable laws or regulations. For example, the IRS may amend the agreement as needed to address changes in law or administrative practice. The agreement also may be modified by mutual agreement of the parties. Either party can terminate the agreement prior to the end of its term by delivering a notice of termination. However, the IRS will terminate the agreement only in certain specified circumstances involving a "significant change in circumstances" or an "event of default" (as defined in the agreement).

SECTION 5. APPLICATION FOR WP or WT STATUS

.01 *Where to Apply*. To apply for WP or WT status, a foreign partnership or trust must submit the information required by this Section 5 to:

Internal Revenue Service
LMSB:FS:QI
290 Broadway
New York, NY 10007–1867
USA

.02 *Contents of the Application*. A prospective WP or WT must submit an application to become a WP or WT. An application must include the information specified in this section 5.02, and any additional information and documentation requested by the IRS:

(1) A statement identifying what type of entity the applicant is (*i.e.*, a foreign partnership or a foreign simple or grantor trust) and that it requests to enter into a WP or WT agreement with the IRS.

(2) The applicant's name, address, and employer identification number(s) (EIN), if any.

(3) The country in which the applicant was created or organized and a description of the applicant's business.

(4) A list of the titles of those persons who will be the responsible parties for performance under the Agreement and the names, addresses, and telephone numbers of those persons as of the date the application is submitted.

(5) A list describing, as of the date the application is submitted, the type of partners, beneficiaries or owners (*e.g.*, U.S., foreign, treaty benefit claimant, or intermediary or flow-through), the number (and percentage interest in partnership capital, partnership profits, and partnership losses (noting any special allocations or similar provisions)) of partners, beneficiaries or owners within each type, and the estimated value of U.S. investments that the WP or WT agreement will cover.

(6) A general description, as of the date the application is submitted, of U.S. assets by type (*e.g.*, U.S. securities, U.S. real estate), including assets held by U.S. custodians, and their approximate aggregate value by type.

(7) A completed Form SS-4 (*Application for Employer Identification Number*)

to apply for a withholding foreign partnership or trust Employer Identification Number (WP-EIN, WT-EIN) to be used solely for WP or WT reporting and filing purposes. An applicant must apply for a WP-EIN or WT-EIN even if it already has another EIN. The WP-EIN or WT-EIN will be in addition to any EIN the WP or WT already has, which should be retained.

(8) A completed WP or WT agreement, as set forth in Appendix 1 or 2, executed as provided in section 6.

SECTION 6. EXECUTING THE WP OR WT AGREEMENT

The text of the WP agreement is set forth in Appendix 1. The text of the WT agreement is set forth in Appendix 2. Upon receipt and review of an application to become a WP or WT, the IRS will complete the agreement based on the information provided by WP or WT (*e.g.*, insertion of the WP's name, etc.). Therefore, a prospective WP or WT should ensure that it has provided to the IRS all of the information that is required to complete the agreement. It may be necessary for the IRS to contact the potential WP or WT, or its authorized representative, to obtain additional information. Once the IRS has obtained all the information required to complete the agreement, the IRS will send two unsigned copies of the agreement to the prospective WP or WT for signature. Both copies of the agreement should be signed by a person with the authority to sign the agreement and should be returned to the IRS at the address specified in section 5.01. The IRS will sign the agreement and return one of the originals to the WP or WT.

SECTION 7. REQUEST FOR COMMENTS

Treasury and the IRS request comments on the proposed withholding foreign partnership and withholding foreign trust agreements attached as appendices to this notice. After consideration of any comments received, Treasury and the IRS intend to publish a revenue procedure containing the final text of these agreements. In addition, the IRS may consider adapting the proposed withholding foreign partnership and withholding foreign trust agreements to the unique circumstances of certain classes of foreign partnerships and trusts. For instance, the IRS may consider incorporating documentation provisions similar to the provisions in the QI agreement in the case of certain foreign partnerships and trusts that are required by law in the jurisdiction of organization to comply with know-your-customer rules for obtaining documentation confirming the identity of partners, beneficiaries, or owners (or the interests in which are generally held through institutions that are subject to know-your-customer rules); and

(i) the offer and sale of interests in which are subject to securities regulation in that jurisdiction; or

(ii) the interests in which are publicly traded on an established securities exchange or continuously offered and sold to the general public (and the partnership is not classified as a corporation pursuant to section 7704).

In addition, the IRS understands that certain small partnerships or small family trusts may find the WP or WT agreement to be a desirable alternative to acting as a nonwithholding partnership or trust but may nevertheless require adaptations to the agreements as drafted.

The IRS specifically requests comments identifying such classes of foreign partnerships or trusts, suggesting possible adaptations of the agreements for such cases and analyzing the feasibility of any such suggestions.

Written comments must be received by July 22, 2002. Send comments to CC:DOM:CORP:R (NOT–151112–01), Room 5228, Internal Revenue Service, Ben Franklin Station, Washington, DC 20224. Alternatively, comments may be hand delivered between the hours of 8:00 AM and 5:00 PM to: CC:DOM:CORP:R (NOT–151112–01), Courier's Desk, Internal Revenue Service, 1111 Constititution Ave. NW, Washington, DC.

SECTION 8. CONTACT INFORMATION

For further information regarding this Notice, contact Carl Cooper or Laurie Hatten-Boyd of the Office of the Associate Chief Counsel (International), Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Mr. Cooper and Ms. Hatten-Boyd may be contacted by telephone at 202–622–3840 (not a toll-free call).

APPENDIX 1

Withholding Foreign Partnership Agreement

SECTION 1. PURPOSE AND SCOPE

SECTION 2. DEFINITIONS

SECTION 3. WITHHOLDING RESPONSIBILITY

THIS AGREEMENT is made in duplicate under and in pursuance of section 1441 of the Internal Revenue Code of 1986, as amended, (the "Code") and Treasury Regulation § 1.1441–5(c)(2) by and between ______________, (referred to as "WP"), and the INTERNAL REVENUE SERVICE (the "IRS"):

WHEREAS, WP has submitted an application in accordance with **Revenue Procedure 2002–xx** to be a withholding foreign partnership for purposes of Treas. Reg. § 1.1445–5(c)(2);

WHEREAS, WP and the IRS desire to enter into an agreement to establish WP's rights and obligations regarding documentation, withholding, information reporting, tax return filing, deposits, and adjustment procedures under sections 1441, 1442, 1443, 1461, 6031, 6302, 6402, and 6414 of the Code with respect to certain types of payments;

NOW, THEREFORE, in consideration of the following terms, representations, and conditions, the parties agree as follows:

SECTION 1. PURPOSE AND SCOPE

Sec. 1.01. General Obligations. Except as otherwise provided in this Agreement, WP's obligations with respect to income distributed to, or included in the distributive shares of, its partners are governed by the Code and the regulations thereunder. WP may act in its capacity as a withholding foreign partnership pursuant to this Agreement only for payments of amounts subject to NRA withholding that are distributed to, or included in the distributive shares of, its direct partners. WP is required to act as a withholding foreign partnership for all such amounts paid to WP, or included in WP's distributive share, by any withholding agent to which WP has provided a Form W-8IMY that represents that WP is acting as a withholding foreign partnership with respect to such amounts. WP must act as a withholding foreign partnership for any such amounts paid with respect to such a Form W-8IMY that are distributed to, or included in the distributive shares of, its direct foreign partners. WP may also act as a withholding foreign partnership for such amounts that are distributed to, or included in the distributive shares of, its direct partners that are U.S. persons. In no event may WP act as a withholding foreign partnership for amounts subject to NRA withholding that are distributed to, or included in the distributive shares of, passthrough partners or indirect partners. For passthrough partners and indirect partners, WP must act as a nonwithholding foreign partnership.

Sec. 1.02. Parties to the Agreement. This Agreement applies to WP and the IRS.

SECTION 2. DEFINITIONS

For purposes of this Agreement, the terms listed below are defined as follows:

Sec. 2.01. Agreement. "Agreement" means this Agreement between WP and the IRS. All appendices to this Agreement and WP's application to become a withholding foreign partnership are incorporated into this Agreement by reference.

Sec. 2.02. Amounts Subject to NRA Withholding. An "amount subject to NRA withholding" is an amount described in Treas. Reg. § 1.1441–2(a). An amount subject to NRA withholding shall not include interest paid as part of

the purchase price of an obligation sold between interest payment dates or original issue discount paid as part of the purchase price of an obligation sold in a transaction other than the redemption of such obligation, unless the sale is part of a plan the principal purpose of which is to avoid tax and WP has actual knowledge or reason to know of such plan.

Sec. 2.03. Chapter 3 of the Code. Any reference to "chapter 3 of the Code" means sections 1441, 1442, 1443, 1461, 1463, and 1464 of the Code.

Sec. 2.04. Chapter 61 of the Code. Any reference to "chapter 61 of the Code" means sections 6031, 6041, 6042, 6045, 6049, and 6050N of the Code.

Sec. 2.05. External Auditor. An "external auditor" is any approved auditor listed in Appendix A of this Agreement that WP engages to perform the audits required by section 8 of this Agreement.

Sec. 2.06. Flow-Through Entity. A flow-through entity is a foreign partnership described in Treas. Reg. § 301.7701–2 or 3 (other than a withholding foreign partnership), a foreign trust that is described in section 651(a) of the Code, or a foreign trust all or a portion of which is treated as owned by the grantor or other person under sections 671 through 679 of the Code (other than a withholding foreign trust). For an item of income for which a treaty benefit is claimed, an entity is also a flow-through entity to the extent it is treated as fiscally transparent under section 894 and the regulations thereunder.

Sec. 2.07. Foreign Person. A "foreign person" is any person that is not a "United States person" and includes a "nonresident alien individual," a "foreign corporation," a "foreign partnership," a "foreign trust," and a "foreign estate," as those terms are defined in section 7701 of the Code.

Sec. 2.08. Form W-8. "Form W-8" means a valid IRS Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*; IRS Form W-8ECI, *Certificate of Foreign Person's Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States*; IRS Form W-8EXP, *Certificate of Foreign Governments and Other Foreign Organizations for United States Tax Withholding*; and IRS Form W-8IMY, *Certificate of Foreign Intermediary, Foreign Partnership, and Certain U.S. Branches for United States Tax Withholding*, as appropriate. It also includes any acceptable substitute form.

Sec. 2.09. Form W-9. "Form W-9" means a valid IRS Form W-9, *Request for Taxpayer Identification Number and Certification*, or any acceptable substitute.

Sec. 2.10. Form 1042. "Form 1042" means an IRS Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons.*

Sec. 2.11. Form 1042-S. "Form 1042-S" means an IRS Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*.

Sec. 2.12. Form 1065. "Form 1065" means an IRS Form 1065, *U.S. Return of Partnership Income*, and the Schedules K-1 associated with that form.

Sec. 2.13. Intermediary. An "intermediary" means any person that acts on behalf of another person, such as a custodian, broker, nominee, or other agent.

Sec. 2.14. Nonwithholding Foreign Partnership. A "nonwithholding foreign partnership" is any foreign partnership that is not acting as a withholding foreign partnership.

Sec. 2.15. NRA Withholding. For purposes of this agreement, "nonresident alien (NRA) withholding" is any withholding required under chapter 3 of the Code (other than sections 1445 or 1446), whether the payment subject to withholding is made to an individual or to an entity.

Sec. 2.16. Overwithholding. The term "overwithholding" means the excess of the amount actually withheld over the amount required to be withheld under chapter 3 of the Code.

Sec. 2.17. Partnership and Partner. The terms "partnership" and "partner" are defined in section 7701(a)(2) of the Code and the regulations thereunder. A direct partner is a partner, other than an intermediary or flow-through entity, that is not itself a withholding foreign partnership or withholding foreign trust, for which WP acts as a withholding foreign partnership. An indirect partner is a person that owns a partnership interest in WP though one or more passthrough partners. A passthrough partner is a direct or indirect partner in WP that is an intermediary or flow-through entity. As provided in Section 2.06 of this Agreement, a withholding foreign partnership or withholding foreign trust is not a flow-through entity and thus is not a passthrough partner.

Sec. 2.18. Payment. A "payment" is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. See Treas. Reg. § 1.1441–2(e).

Sec. 2.19. Reduced Rate of Withholding. A "reduced rate of withholding" means a rate of withholding that is less than 30 percent, either as a result of a reduction in withholding under the Code or as a result of a reduction in withholding under an income tax treaty.

Sec. 2.20. Reportable Amount. A "reportable amount" means an amount subject to NRA withholding (as defined in section 2.02 of this Agreement); U.S. source deposit interest; and U.S. source interest or original issue discount paid on the redemption of short-term obligations. The term does not include payments on deposits with banks and other financial institutions that remain on deposit for two weeks or less. It also does not include amounts of original issue discount arising from a sale and repurchase transaction completed within a period of two weeks or less, or amounts described in Treas. Reg. § 1.6049–5(b)(7), (10), or (11) (relating to certain foreign targeted registered obligations and certain obligations issued in bearer form).

Sec. 2.21. Reporting Pool. A reporting pool is defined in section 5.03 of this Agreement.

Sec. 2.22. Schedule K-1. "Schedule K-1" or "K-1" is the schedule associated with the Form 1065 that itemizes an individual Partner's Share of Income, Credits, Deductions, etc.

Sec. 2.23. TIN. A "TIN" is a U.S. taxpayer identification number.

Sec. 2.24. Underwithholding. "Underwithholding" means the excess of the amount required to be withheld under chapter 3 of the Code over the amount actually withheld.

Sec. 2.25. U.S. Person. A "United States (or U.S.) person" is a person described in section 7701(a)(30) of the Code, the U.S. government (including an agency or instrumentality thereof), a State of the United States (including an agency

or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof).

Sec. 2.26. Withholding Agent. A "withholding agent" has the same meaning as set forth in Treas. Reg. § 1.1441–7(a) and includes a payor. As used in this Agreement, the term generally refers to the person making a payment to a withholding foreign partnership.

Sec. 2.27. Withholding Foreign Partnership (or WP). A "withholding foreign partnership" is a person, described in Treas. Reg. § 1.1441–5(c)(2), that has entered into a withholding agreement with the IRS to be treated as a withholding foreign partnership and is acting in its capacity as a withholding foreign partnership.

Sec. 2.28. Withholding Foreign Partnership (or WP) EIN. A "withholding foreign partnership EIN" or "WP-EIN" means the employer identification number assigned by the IRS to a withholding foreign partnership. WP's WP-EIN is only to be used when WP is acting as a withholding foreign partnership. For example, WP must give a withholding agent its non-WP EIN, if any, rather than its WP-EIN, if it is not acting as a withholding foreign partnership and a taxpayer identification number is required.

Sec. 2.29. Withholding Statement. The term "withholding statement" is defined in section 5.02 of this Agreement.

Sec. 2.30. Other Terms. Any term not defined in this section has the same meaning that it has under the Code, the income tax regulations under the Code, or any applicable income tax treaty.

SECTION 3. WITHHOLDING RESPONSIBILITY

Sec. 3.01. NRA Withholding Responsibility. WP is subject to the withholding and reporting provisions applicable to withholding agents under chapter 3 of the Code. Under chapter 3, a withholding agent must withhold 30 percent of any payment of an amount subject to NRA withholding made to a partner that is a foreign person unless the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a payee that is a U.S. person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding. When it is acting as a withholding foreign partnership, WP must assume NRA withholding responsibility for amounts subject to NRA withholding that are distributed to, or included in the distributive share of, any direct partner, and WP must withhold the amount required to be withheld under chapter 3 of the Code. WP must provide a Form W-8IMY that certifies to a withholding agent that makes a payment of such amounts that WP is acting as a withholding foreign partnership, and WP must identify such amounts on the withholding statement associated with that Form W-8IMY. WP is not required to withhold when it pays such amounts to another withholding foreign partnership or withholding foreign trust that has certified to WP on Form W-8IMY that it is acting as a withholding foreign partnership or withholding foreign trust with respect to such identified amounts. WP is not required to act as a withholding foreign partnership for all amounts that it receives from a withholding agent. WP may not act as a withholding foreign partnership for amounts distributed to, or included in the distributive share of, passthrough partners or indirect partners. WP must act as a nonwithholding foreign partnership for such amounts. When WP is not acting as a withholding foreign partnership, WP must: 1) provide to the withholding agent a Form W-8IMY with Part VI completed; 2) identify such amounts on the withholding statement associated with that Form W-8IMY; and 3) provide the documentation and information required by Treas. Reg. §1.1441–5(c)(3)(iii) and (iv).

Sec. 3.02. Timing of Withholding. WP must withhold on the date it makes a distribution to a direct foreign partner that includes an amount subject to NRA withholding. To the extent a direct foreign partner's distributive share of income subject to withholding has not actually been distributed to the direct foreign partner, WP must withhold on the direct foreign partner's distributive share on the earlier of the date that the statement required under section 6031(b) (schedule K-1) is mailed or otherwise provided to the partner or the due date for furnishing the statement (whether or not WP is required to prepare and furnish the statement).

Sec. 3.03. Deposit Requirements. WP must deposit amounts withheld under chapter 3 of the Code with a Federal Reserve bank or authorized financial institution at the time and in the manner provided under section 6302 of the Code (see Treas. Reg. § 1.6302–2(a) or § 31.6302–1(h)).

SECTION 4. DOCUMENTATION REQUIREMENTS

Sec. 4.01. Documentation Requirements. WP agrees to obtain, review, and maintain Forms W-8 and W-9 in accordance with this section 4. WP must obtain a Form W-8 or W-9 from every direct partner prior to the time that withholding is required. WP agrees to make documentation (together with any associated withholding statements and other documents or information) available upon request for inspection by WP's external auditor. WP represents that none of the laws to which it is subject prohibits disclosure of the identity of any partner or corresponding partner information to WP's external auditor. WP may rely on the Forms W-8 and W-9 it obtains under this section 4 as the basis for determining its withholding and reporting obligations.

Sec. 4.02. Documentation for Foreign Partners. WP may treat a direct partner as a foreign beneficial owner if the direct partner provides a Form W-8 that supports such status. WP may treat a direct partner that has provided a Form W-8 as entitled to a reduced rate of NRA withholding if all the requirements for a reduced rate are met and the Form W-8 provided by the direct partner supports entitlement to a reduced rate. Sections 4.03 through 4.06 of this Agreement describe the specific documentation requirements necessary for obtaining a reduced rate of withholding in certain circumstances.

Sec. 4.03. Treaty Claims. WP may not reduce the rate of withholding based on a direct partner's claim of treaty benefits unless WP obtains from the partner a Form W-8BEN with Part II of the form properly completed, including the appropriate limitation on benefits and section 894 certifications.

Sec. 4.04. Documentation for International Organizations. WP may not treat a direct partner as an international organization entitled to an exemption from withholding under section 892 of the Code unless WP obtains a Form

W-8EXP from the international organization and the name provided on the Form W-8EXP is the name of an entity designated as an international organization by executive order pursuant to 22 United States Code 288 through 288(f). If an international organization is not claiming benefits under section 892 of the Code but under another Code exception, the provisions of sections 4.02 of this Agreement apply rather than the provisions of this section 4.04.

Sec. 4.05. Documentation for Foreign Governments and Foreign Central Banks of Issue.

(A) **Documentation For a Foreign Government or Foreign Central Bank of Issue Claiming an Exemption From Withholding Under Section 892 or Section 895**. WP may not treat a direct partner as a foreign government or foreign central bank of issue exempt from withholding under section 892 or 895 of the Code unless—

(1) WP receives from the direct partner a Form W-8EXP establishing that the direct partner is a foreign government or foreign central bank of issue;

(2) The income distributed to, or included in the distributive share of, the direct partner is the type of income that qualifies for an exemption from withholding under section 892 or 895; and

(3) WP does not know, or have reason to know, that the direct partner is a controlled commercial entity, that the income owned by the foreign government or foreign central bank of issue is being received from a controlled commercial entity, or that the income is from the disposition of an interest in a controlled commercial entity.

(B) **Treaty Exemption**. WP may not treat a direct partner as a foreign government or foreign central bank of issue entitled to a reduced rate of withholding under an income tax treaty unless it obtains a Form W-8BEN that, under section 4.03 of this Agreement, is sufficient to obtain a reduced rate of withholding under a treaty.

(C) **Other Code Exception**. If a foreign government or foreign central bank of issue is not claiming benefits under section 892 or section 895 of the Code but under another Code exception (*e.g.*, the portfolio interest exception under sections 871(h) or 881(c) of the Code), the provisions of section 4.02 of this Agreement apply rather than the provisions of this section 4.05.

Sec. 4.06. Documentation for Foreign Tax-Exempt Organizations.

(A) **Reduced Rate of Withholding Under Section 501**. WP may not treat a direct partner as a foreign organization described under section 501(c) of the Code, and therefore exempt from withholding (or, if the direct partner is a foreign private foundation, subject to withholding at a 4-percent rate under section 1443(b) of the Code) unless WP obtains a valid Form W-8EXP on which Part III of the form is completed.

(B) **Treaty Exemption**. WP may not treat a direct partner as a foreign organization that is tax exempt or entitled to a reduced rate of withholding under an income tax treaty unless WP obtains a Form W-8BEN that, under section 4.03 of this Agreement, is sufficient to obtain a reduced rate of withholding under a treaty.

(C) **Other Exceptions**. If a tax-exempt entity is not claiming a reduced rate of withholding because it is an organization described under section 501(c) of the Code or under an income tax treaty, but is claiming a reduced rate of withholding under another Code exception, the provisions of section 4.02 of this Agreement apply rather than the provisions of this section 4.06.

Sec. 4.07. Documentation for Passthrough Partners. WP shall not act as a withholding foreign partnership with respect to an amount subject to withholding distributed to, or included in the distributive share of, a passthrough partner. WP must forward that passthrough partner's documentation (and associated withholding statement and documentation of indirect partners) to the withholding agent from whom WP receives the amount subject to withholding. WP may act as a withholding foreign partnership for payments made to partners that are themselves withholding foreign partnerships or withholding foreign trusts.

Sec. 4.08. Documentation for U.S. Exempt Recipients. WP shall not treat a partner as a U.S. exempt recipient unless WP obtains a Form W-9 from the partner on which the partner writes "Exempt" in Part II of the Form.

Sec. 4.09. Documentation for U.S. Non-Exempt Recipients. WP shall not treat a partner as a U.S. non-exempt recipient unless WP obtains a Form W-9 from the partner.

Sec. 4.10. Documentation Validity. WP may not rely on Forms W-8 or W-9 if WP has actual knowledge or reason to know that the information or statements contained in the forms are unreliable or incorrect. Once WP knows, or has reason to know, that a Form W-8 or W-9 provided by a direct partner is unreliable or incorrect, WP must obtain a new Form W-8 or W-9 prior to the time withholding is required.

Sec. 4.11. Documentation Validity Period.

(A) **Form W-8**. WP may rely on a properly completed Form W-8 until its validity expires under Treas. Reg. § 1.1441–1(e)(4)(ii).

(B) **Form W-9**. WP may rely on a properly completed Form W-9 as long as it has not been informed by the IRS or another withholding agent that the form is unreliable.

Sec. 4.12. Maintenance and Retention of Documentation.

(A) **Maintaining Documentation**. WP shall maintain Forms W-8 and W-9 by retaining the original documentation, a certified copy, a photocopy, a microfiche, or by electronic storage or similar means of record retention.

(B) **Retention Period**. WP shall retain a direct partner's Form W-8 or W-9 obtained under this section 4 for as long as it may be relevant to the determination of WP's tax liability under this agreement.

SECTION 5. WITHHOLDING FOREIGN PARTNERSHIP WITHHOLDING CERTIFICATE

Sec. 5.01. WP Withholding Certificate. WP agrees to furnish a withholding foreign partnership withholding certificate to each withholding agent from which it receives amounts subject to NRA withholding as a withholding foreign partnership. The withholding foreign partnership withholding certificate is a Form W-8IMY (or acceptable substitute form) that certifies that WP is acting as a withholding foreign partnership, contains WP's WP-EIN, and provides all other information required by the form. WP is

not required to disclose, as part of that Form W-8IMY or its withholding statement, any information regarding the identity of a direct partner.

Sec. 5.02. Withholding Statement. WP agrees to provide to each withholding agent from which WP receives amounts subject to NRA withholding as a withholding foreign partnership a written statement (the "withholding statement") identifying the amounts for which WP acts as a withholding foreign partnership. The statement forms an integral part of the Form W-8IMY. The withholding statement may be provided in any manner, and in any form, to which WP and the withholding agent mutually agree.

Sec. 5.03. Withholding Rate Pools. When it is acting as a withholding foreign partnership, WP must assume withholding responsibility for amounts subject to withholding that are distributed to, or included in the distributive shares of, its direct partners. Accordingly, withholding rate pool information is not required as part of WP's withholding statement.

SECTION 6. TAX RETURN OBLIGATIONS

Sec. 6.01. Form 1042 Filing Requirement.

(A) In General. WP shall file a return on Form 1042, whether or not WP withheld any amounts under chapter 3 of the Code, on or before March 15 of the year following any calendar year in which WP acts as a withholding foreign partnership. In addition to the information specifically requested on Form 1042 and the accompanying instructions, WP shall attach a statement setting forth the amounts of any overwithholding or underwithholding adjustments made under Treas. Reg. § 1.1461–2 and sections 7.01 and 7.03 of this Agreement, and an explanation of the circumstances that resulted in the over- or under- withholding.

(B) Extensions for Filing Returns. WP may request an extension of the time for filing Form 1042, or any of the information required to be attached to the form, by submitting Form 2758, *Application for Extension of Time to File Certain Excise, Income, Information, and Other Returns*, on or before the due date of the return. The application must be in writing, properly signed by a duly authorized agent of WP, and shall clearly set forth the following:

(1) The calendar year for which the extension is requested; and

(2) A full explanation of the reason(s) for requesting the extension to assist the IRS in determining the period of extension, if any, that will be granted.

Sec. 6.02. Form 1042-S Reporting: General Rule. Unless WP has made a pooled reporting (PR) election pursuant to section 6.03 of this Agreement, WP is required to file separate Forms 1042-S for each direct partner to whom WP distributes, or in whose distributive share is included, an amount subject to NRA withholding. WP must file separate Forms 1042-S by income code, exemption code, recipient code, and withholding rate. WP must file its Forms 1042-S in the manner required by the regulations under chapter 3 of the Code and the instructions to the form, including any requirement to file the forms magnetically or electronically. Any Form 1042-S required by this section 6 shall be filed on or before March 15 following the calendar year in which withholding, if any, was required under section 3.02 of this agreement. WP may request an extension of time to file Forms 1042-S by submitting Form 8809, *Request for Extension of Time to File Information Returns*, by the due date of Forms 1042-S in the manner required by Form 8809.

Sec. 6.03. Form 1042-S Reporting: Special Rule for PR Election. If WP has made the PR election pursuant to this section 6.03, WP is not required to file Forms 1042-S for amounts distributed to, or included in the distributive share of, each separate direct partner for whom such reporting would otherwise be required. Instead, WP shall file a separate Form 1042-S for each reporting pool. A reporting pool consists of income that falls within a particular withholding rate and within a particular income code, exemption code, and recipient code as determined on Form 1042-S. WP may use a single recipient code for all reporting pools except for amounts paid to foreign tax-exempt recipients, for which a separate recipient code must be used. For this purpose, a foreign tax-exempt recipient includes any organization that is not subject to NRA withholding and is not liable to tax in its country of residence because it is a charitable organization, a pension fund, or a foreign government. WP must make the PR election at the time this agreement is executed by signing the election statement on the signature page of this agreement. Once made, the PR election remains in effect for the entire term of this agreement beginning on the date the agreement becomes effective and ending on the date of its expiration or termination under section 9 of the Agreement. WP must make a new election for each renewal term of this agreement. If WP makes the PR election, WP cannot revoke it prior to the end of the term for which WP has made the PR election. If WP did not make the PR election at the time this agreement was executed, then WP may make a PR election only by terminating this agreement pursuant to section 9.03 and requesting to enter into a new agreement.

Sec. 6.04. Form 1065 Filing Requirement. If WP is required to file Form 1065 and Schedules K-1 under Treas. Reg. § 1.6031(a)–1, then WP shall file Form 1065 and Schedules K-1 in accordance with the regulations and the instructions for the form.

Sec. 6.05. Retention of Returns. WP shall retain Forms 1065 and 1042 for the period of the applicable statute of limitations on assessments and collection under the Code.

SECTION 7. ADJUSTMENTS FOR OVER- AND UNDER-WITHHOLDING; REFUNDS

Sec. 7.01. Adjustments for NRA Overwithholding by WP. WP may make an adjustment for amounts paid to its direct partners that it has overwithheld under chapter 3 of the Code by applying either the reimbursement or set-off procedures described in this section within the time period prescribed for those procedures.

(A) Reimbursement Procedure. WP may repay its partners for an amount overwithheld and reimburse itself by reducing, by the amount of tax actually repaid to the partners, the amount of any subsequent deposit of tax required to be made by WP under section 3.03 of this Agreement. For purposes of this section 7.01(A), an amount that is overwithheld shall be applied in order of time to each

of WP's subsequent deposit periods in the same calendar year to the extent that the withholding taxes required to be deposited for a subsequent deposit period exceed the amount actually deposited. An amount overwithheld in a calendar year may be applied to deposit periods in the calendar year following the calendar year of overwithholding only if:

(1) WP states on a Form 1042-S filed by March 15 of the calendar year following the calendar year of overwithholding, the amount of tax withheld and the amount of any actual repayments; and

(2) WP states on a Form 1042, filed by March 15 of the calendar year following the calendar year of overwithholding, that the filing of the Form 1042 constitutes a claim for credit in accordance with Treas. Reg. § 1.6414–1.

(B) Set-Off Procedure. WP may repay its partners by applying the amount overwithheld against any amount which otherwise would be required under chapter 3 of the Code to be withheld by WP before the earlier of March 15 of the calendar year following the calendar year of overwithholding or the date that the Form 1042-S is actually filed with the IRS. For purposes of making a return on Form 1042 or 1042-S for the calendar year of overwithholding, and for purposes of making a deposit of the amount withheld, the reduced amount shall be considered the amount required to be withheld from such income under chapter 3 of the Code.

Sec. 7.02. Collective Credit or Refund Procedures for NRA Overwithholding. If WP has made a PR election and it has overwithheld under chapter 3 of the Code on amounts subject to NRA withholding paid to WP's direct partners during a calendar year and the amount has not been recovered under the reimbursement or set-off procedures under sections 7.01 of this Agreement, WP may request a credit or refund of the total amount overwithheld by following the procedures of this section 7.02. WP shall follow the procedures set forth under sections 6402 and 6414 of the Code, and the regulations thereunder, to claim the credit or refund. No credit or refund will be allowed after the expiration of the statutory period of limitation for refunds under section 6511 of the Code. WP may use the collective refund procedures under this section 7.02 only if the following conditions are met:

(**A**) WP must not have issued Forms 1042-S to the direct partners who were subjected to overwithholding;

(**B**) WP must submit together with its amended return on which it claims a credit or refund a statement of the reason for the overwithholding;

(**C**) WP must submit together with its amended return on which it claims a credit or refund a statement that it has repaid the amount of overwithholding to the appropriate direct partners prior to filing the claim for credit or refund; and

(**D**) WP must retain a record showing that it repaid the direct partners the amount of the overwithholding.

Sec. 7.03. Adjustments for NRA Underwithholding. If WP knows that an amount should have been withheld under chapter 3 of the Code from a previous payment to a direct partner but was not withheld, WP may either withhold from future payments made to the same direct partner or satisfy the tax from the direct partner's proportionate share of assets over which it has control. The additional withholding or satisfaction of the tax owed may only be made before the due date of the Form 1042 (not including extensions) for the calendar year in which the underwithholding occurred.

Sec. 7.04. NRA Underwithholding after Form 1042 Filed. If, after a Form 1042 has been filed for a calendar year, WP, WP's external auditor, or the IRS determines that, due to WP's failure to carry out its obligations under this Agreement, WP has underwithheld tax for such year, WP shall file an amended Form 1042 to report and pay the underwithheld tax. WP shall pay the underwithheld tax, the interest due on the underwithheld tax, and any applicable penalties, at the time of filing the amended Form 1042. If WP fails to file an amended return, the IRS shall make such return under section 6020 of the Code.

Sec. 7.05. Special Rule Regarding Failure to Deposit Penalties. Solely for purposes of applying section 6656 of the Code (failure to make deposit of taxes), WP will not be considered to have made an underpayment of a deposit of NRA withholding taxes if the conditions of this paragraph are met. The conditions of this paragraph are that—

(**A**) WP makes its deposits within the time (deposit period) required by section 6302 of the Code;

(**B**) The deposit is not less than 90 percent of the aggregate amount of the tax required to be withheld under chapter 3 of the Code during the deposit period applicable to WP; and

(**C**) WP determines the difference between the total amount required to be deposited and the amount actually deposited as of the end of the 3rd, 6th, 9th, and 12th months of the calendar year and the difference is deposited no later than the 15th day of the second following month (*i.e.*, May 15, August 15, November 15 and February 15, respectively). In determining whether there has been an underpayment, reimbursements and set-offs shall be taken into account.

SECTION 8. EXTERNAL AUDIT PROCEDURES

Sec. 8.01. In General. Unless WP requests an IRS audit in lieu of an external audit, the IRS agrees not to conduct an on-site audit of WP with respect to withholding and reporting obligations covered by this Agreement provided that an external auditor designated in Appendix A of this Agreement conducts an audit of WP in accordance with this section 8. WP shall permit the external auditor to have access to all relevant records of WP for purposes of performing the external audit, including information regarding specific partners. WP shall permit the IRS to communicate directly with the external auditor and to review the audit procedures followed by the external auditor. WP represents that there are no legal prohibitions that prevent the external auditor from examining any information relevant to the external audit to be performed under this section 8 and that there are no legal prohibitions that prevent the IRS from communicating directly with the auditor. WP shall permit the IRS to examine the external auditor's work papers and reports.

Sec. 8.02. Designation of External Auditor. WP's external auditor must be one of the auditors listed in Appendix A of this Agreement, unless WP and the IRS agree, prior to the audit, to substitute another auditor. WP shall not propose an external auditor unless it has a reasonable belief that the auditor is subject to laws, regulations, or rules that impose sanctions

for failure to exercise its independence and to perform the audit competently. The IRS has the right to reject a proposed external auditor, or to revoke its acceptance of an external auditor, if the IRS, in its sole discretion, reasonably believes that the auditor is not independent or cannot perform an effective audit under this Agreement.

Sec. 8.03. Timing External Audits: General Rule. Unless WP has made a PR election, WP shall have the external auditor conduct an external audit only at such time and only for such calendar years as the IRS directs.

Sec. 8.04. Timing External Audits: Special Rule for PR Election. If WP has made a PR election, WP shall have the external auditor conduct an audit after the close of every other calendar year that this Agreement is in effect. The auditor shall examine the two previous calendar years. For example, the first audit will occur in the third calendar year that the agreement is in effect and the external auditor will examine calendar years one and two.

Sec. 8.05. Scope of External Audit. The external auditor shall verify whether WP is in compliance with this Agreement by conducting an audit that meets the requirements of this section 8.05. The report, described in section 8.06 of this Agreement, must disclose that the external auditor has, at a minimum, performed the following checks listed in this section 8.05, and set forth how each of those checks was performed and the results of the checks. WP's external auditor is encouraged to contact the IRS at the address set forth in section 10.06 of this Agreement and submit an audit plan (which includes, if relevant, the extent to which the external auditor proposes to rely on WP's internal audit procedures) prior to performing the audit so that the audit may be conducted in the most efficient and least costly manner possible.

(**A**) **Documentation**. The external auditor must review information contained in partner files to determine whether the documentation requirements of section 4 of this Agreement are being met.

(**B**) **Withholding Responsibilities**. The external auditor must—

(**1**) Perform test checks of direct partners, to verify that WP is withholding the proper amounts.

(**2**) Verify that amounts withheld were timely deposited in accordance with section 3.03 of this Agreement.

(**C**) **Return Filing and Information Reporting**. The external auditor must—

(**1**) Obtain copies of original and amended Forms 1042, and any schedules, statements, or attachments required to be filed with those forms, and determine whether the amounts of income, taxes, and other information reported on those forms are accurate by—

(**i**) Reviewing work papers;

(**ii**) Reviewing Forms W-8IMY, together with the associated withholding statements, that WP has provided to withholding agents;

(**iii**) Reviewing copies of Forms 1042-S that withholding agents have provided WP;

(**iv**) Reviewing account statements from withholding agents;

(**v**) Reviewing correspondence between WP and withholding agents; and

(**vi**) Interviewing personnel responsible for preparing the Form 1042 and the work papers used to prepare those forms.

(**2**) Obtain copies of original and corrected Forms 1042-S and Schedules K-1 together with the work papers used to prepare those forms and determine whether the amounts reported on those forms are accurate by—

(**i**) Reviewing the Forms 1042-S received from withholding agents;

(**ii**) Reviewing the Form 1065, if required;

(**iii**) Reviewing a valid sample of earnings statements issued by WP to direct partners, if any.

(**3**) Thoroughly review the statements attached to amended Forms 1042 filed to claim a refund, ascertain their veracity, and determine the causes of any overwithholding reported and ensure WP did not issue Forms 1042-S to persons whom it included as part of its collective credit or refund.

(**4**) Determine, in the case of collective credits or refunds, that WP repaid the appropriate partners prior to requesting a collective refund or credit.

(**E**) **Change in Circumstances**. The external auditor must verify that in the course of the audit it has not discovered any significant change in circumstances, as described in section 9.05 (A) or (D) of this Agreement.

Sec. 8.06. External Auditor's Report. Upon completion of the audit of WP, the external auditor shall issue a report, or reports, of audit findings directly to the IRS by sending the original report to the IRS at the address set forth in section 10.06 of this Agreement. This report is due by December 31 following the calendar year being audited, or if that date falls on a Saturday or Sunday, the next U.S. business day. The IRS may, however, upon request by the external auditor, extend the due date of the audit report upon good cause. The report must be in writing, in English, and currency amounts must be stated in U.S. dollars. The report must fully describe the scope of the audit, the methodologies (including sampling techniques) used to determine whether WP is in compliance with the provisions of this Agreement, and the result of each such determination. The report must also specifically address each of the items in section 8.05 of this Agreement.

Sec. 8.07. Expanding Scope and Timing of External Audit. Upon review of the external auditor's report, the IRS may request, and WP must permit, the external auditor to perform additional audit procedures.

SECTION 9. EXPIRATION, TERMINATION AND DEFAULT

Sec. 9.01. Term of Agreement: General Rule. If WP has not made a PR election, this Agreement shall be in effect on ______________ and shall continue in force until terminated under 9.03 or 9.04 of this Agreement.

Sec. 9.02. Term of Agreement: Special Rule for PR Election. If WP has made a PR election, this Agreement shall be in effect on ______________ and shall expire on December 31 of the fifth full calendar year after the year in which this Agreement first takes effect. This Agreement may be renewed for additional terms as provided in section 9.08 of this Agreement.

Sec. 9.03. Termination of Agreement. This Agreement may be terminated by either the IRS or WP prior to the end of

its term by delivery of a notice of termination to the other party in accordance with section 10.06 of this Agreement. The IRS, however, shall not terminate the Agreement unless there has been a significant change in circumstances, as defined in section 9.05 of this Agreement, or an event of default has occurred, as defined in section 9.06 of this Agreement, and the IRS determines, in its sole discretion, that the significant change in circumstances or the event of default warrants termination of this Agreement. In addition, the IRS shall not terminate this Agreement in the event of default if WP can establish to the satisfaction of the IRS that all events of default for which it has received notice have been cured within the time period agreed upon. The IRS shall notify WP, in accordance with section 9.07 of this Agreement, that an event of default has occurred and that the IRS intends to terminate the Agreement unless WP cures the default. A notice of termination sent by either party shall take effect on the date specified in the notice.

Sec 9.04. Automatic Termination of Agreement. Notwithstanding Section 9.03 of this Agreement, this Agreement will terminate automatically in the event that the external auditor or the IRS on audit discovers that WP was not in possession of Forms W-8 or W-9, as applicable, for any direct partner at any time that withholding or reporting was required under section 3.02 of this Agreement. The automatic termination will be effective as of December 31 of the year in which the external auditor or the IRS makes that discovery. This Agreement will be reinstated, effective the same date it was automatically terminated, if WP obtains appropriate Forms W-8 or W-9 (that relate to the time withholding or reporting was required) for each such partner before January 31 of the year following the year in which the agreement automatically terminated. In the event of automatic termination of this agreement, WP must pay any underwithholding of tax, interest, and penalties that the IRS determines is attributable to each undocumented direct partner for the period during which the partner was undocumented, and, if WP has made a PR election, WP must file partner specific Forms 1042-S for every foreign direct partner from the earliest time the Forms W-8 or W-9 were required for any undocumented direct partner through the date of termination. After the date of automatic termination of this agreement, WP may not act as a withholding foreign partnership, and must so notify any persons to which WP has furnished a withholding foreign partnership certificate. After the date of automatic termination of this agreement, the IRS may reinstate this agreement (or the IRS may require WP to enter into a new withholding foreign partnership agreement) on such terms and conditions and with such modifications as the IRS may determine.

Sec. 9.05. Significant Change in Circumstances. For purposes of this Agreement, a significant change in circumstances includes, but is not limited to—

(A) any merger, consolidation or division of WP or any change in circumstances that would result in a termination of WP under section 708 of the Code;

(B) A change in U.S. federal law or policy, or applicable foreign law or policy, that affects the validity of any provision of this Agreement, materially affects the procedures contained in this Agreement, or affects WP's ability to perform its obligations under this Agreement;

(C) A ruling of any court that affects the validity of any provision of this Agreement; or

(D) A significant change in WP's business practices that affects WP's ability to meet its obligations under this Agreement.

Sec. 9.06. Events of Default. For purposes of this Agreement, an event of default occurs if WP fails to perform any material duty or obligation required under this Agreement, and includes, but is not limited to, the occurrence of any of the following:

(A) WP fails to implement adequate procedures, accounting systems, and internal controls to ensure compliance with this Agreement;

(B) WP underwithholds an amount that WP is required to withhold under chapter 3 of the Code and fails to correct the underwithholding or to file an amended Form 1042 reporting, and paying, the appropriate tax;

(C) WP makes excessive refund claims;

(D) WP fails to file Forms 1042, 1042-S, 1065 (if required), or Schedules K-1 (if required) by the due date specified on such forms or files forms that are materially incorrect or fraudulent;

(E) WP fails to have an external audit performed when required, WP's external auditor fails to provide its report directly to the IRS on a timely basis, WP fails to cooperate with the external auditor, or WP or its external auditor fails to cooperate with the IRS;

(F) WP fails to inform the IRS within 90 days of any significant change in its business practices to the extent that change affects WP's obligations under this Agreement;

(G) WP fails to cure a default identified by the IRS or by an external auditor;

(H) WP makes any fraudulent statement or a misrepresentation of material fact with regard to this Agreement to the IRS, a withholding agent, or WP's external auditor;

(I) The IRS determines that WP's external auditor is not sufficiently independent to adequately perform its audit function or the external auditor fails to provide an audit report that complies with section 8 of this Agreement;

(J) WP is prohibited by any law from disclosing the identity of a partner or partner information to WP's external auditor;

(K) WP fails to make deposits in the time and manner required by section 3.03 of this Agreement or fails to make adequate deposits, taking into account the procedures of 7.05 of this Agreement; or

(L) WP fails to permit the external auditor to perform additional audit procedures under the provisions of section 8.07 of this Agreement.

Sec. 9.07. Notice and Cure. Upon the occurrence of an event of default, the IRS may deliver to WP a notice of default specifying the event of default that has occurred. WP shall respond to the notice of default within 60 days (60-day response) from the date of the notice of default. The 60-day response shall contain an offer to cure the event of default and the time period in which the cure will be accomplished or shall state the reasons why WP does not agree that an event of default has occurred. If WP does not provide a 60-day response, the IRS may deliver a notice of termination as provided in section 9.03 of this Agreement. If WP provides a 60-day response, the

IRS shall either accept or reject WP's statement that no default has occurred or accept or reject WP's proposal to cure an event of default. If the IRS rejects WP's contention that no default has occurred or rejects WP's proposal to cure a default, the IRS will offer a counter-proposal to cure the event of default. Within 30 days of receiving the IRS's counter-proposal, WP shall notify the IRS (30-day response) whether it continues to maintain that no default has occurred or whether it rejects the IRS's counter-proposal to cure an event of default. If WP's 30-day response states that no default has occurred or it rejects the IRS's counter-proposal to cure, the parties shall seek to resolve their disagreement within 30 days of the IRS's receipt of WP's 30-day response. If a satisfactory resolution has not been achieved at the end of this latter 30-day period, or if WP fails to provide a 30-day response, the IRS may terminate this Agreement by providing a notice of termination in accordance with section 9.03 of this Agreement. If WP receives a notice of termination from the IRS, it may appeal the determination within 30 days of the date of the notice of termination by sending a written notice to the address specified in section 10.06 of this Agreement. If WP appeals the notice of termination, this Agreement shall not terminate until the appeal has been decided. If an event of default is discovered in the course of an external audit, the WP may cure the default, without following the procedures of this section 9.07, if the external auditor's report describes the default and the actions that WP took to cure the default and the IRS determines that the cure procedures followed by WP were sufficient. If the IRS determines that WP's actions to cure the default were not sufficient, the IRS shall issue a notice of default and the procedures described in this section 9.07 shall be followed.

Sec. 9.08. Renewal. If WP has made the PR election under section 6.03 of this agreement and intends to renew this Agreement for an additional term, it shall submit an application for renewal to the IRS no earlier than one year and no later than six months prior to the expiration of this Agreement. Any such application for renewal must contain an update of the information provided by WP to the IRS in connection with the application to enter into this Agreement, and any other information the IRS may request in connection with the renewal process. This Agreement shall be renewed only upon the signatures of both WP and the IRS. Either the IRS or WP may seek to negotiate a new withholding foreign partnership agreement rather than renew this Agreement.

SECTION 10. MISCELLANEOUS PROVISIONS

Sec. 10.01. WP's application to become a withholding foreign partnership and the Appendix to this Agreement are hereby incorporated into and made an integral part of this Agreement. This Agreement, WP's application, and the Appendix to this Agreement constitute the complete agreement between the parties.

Sec. 10.02. This Agreement may be amended by the IRS if the IRS determines that such amendment is needed for the sound administration of the internal revenue laws or internal revenue regulations. The agreement may also be modified by either WP or the IRS upon mutual agreement. Such amendments or modifications shall be in writing.

Sec. 10.03. Any waiver of a provision of this Agreement by the IRS is a waiver solely of that provision. The waiver does not obligate the IRS to waive other provisions of this Agreement or the same provision at a later date.

Sec. 10.04. This Agreement shall be governed by the laws of the United States. Any legal action brought under this Agreement shall be brought only in a U.S. court with jurisdiction to hear and resolve matters under the internal revenue laws of the United States. For this purpose, WP agrees to submit to the jurisdiction of such U.S. court.

Sec. 10.05. WP's rights and responsibilities under this Agreement cannot be assigned to another person.

Sec. 10.06. Notices provided under this Agreement shall be mailed registered, first class airmail. Notice shall be directed as follows:

To the IRS:

Internal Revenue Service
LMSB:FS:QI
290 Broadway
New York, NY 10007–1867
USA

All notices sent to the IRS must include the WP's WP-EIN.

To WP:

____
____
____
____

Sec. 10.07. WP, acting in its capacity as a withholding foreign partnership or in any other capacity, does not act as an agent of the IRS, nor does it have the authority to hold itself out as an agent of the IRS.

IN WITNESS WHEREOF, the above parties have subscribed their names to these presents, in duplicate.

Signed this day of ,

____

(name and title of person signing for WP)

____

(name and title of person signing for IRS)

PR Election Statement

By signing hereunder, WP makes the PR election under section 6.03 of this Agreement.

____

(name and title of person signing for WP)

Appendix A

WP and the IRS agree that any of the following auditors may be used by WP to perform the external audits required by section 8 of this Agreement.

[Names, addresses, telephone and fax numbers of external auditors.]

APPENDIX 2

Withholding Foreign Trust Agreement

SECTION 1. PURPOSE AND SCOPE

THIS AGREEMENT is made in duplicate under and in pursuance of section 1441 of the Internal Revenue Code of 1986, as amended, (the "Code") and Treasury Regulation § 1.1441–5(e)(5)(v) by and between ______________, (referred to as "WT"), and the INTERNAL REVENUE SERVICE (the "IRS"):

WHEREAS, WT has submitted an application in accordance with **Revenue Procedure 2002–xx** to be a withholding foreign trust for purposes of Treas. Reg. § 1.1445–5(e)(5)(v);

WHEREAS, WT and the IRS desire to enter into an agreement to establish WT's rights and obligations regarding documentation, withholding, information reporting, tax return filing, deposits, and adjustment procedures under sections 1441, 1442, 1443, 1461, 6048, 6302, 6402, and 6414 of the Code with respect to certain types of payments;

NOW, THEREFORE, in consideration of the following terms, representations, and conditions, the parties agree as follows:

SECTION 1. PURPOSE AND SCOPE

Sec. 1.01. General Obligations. Except as otherwise provided in this Agreement, WT's obligations with respect to income distributed to, or included in the distributive shares of, its beneficiaries or owners are governed by the Code and the regulations thereunder. WT may act in its capacity as a withholding foreign trust pursuant to this Agreement only for payments of amounts subject to NRA withholding that are distributed to, or included in the distributive shares of, its direct beneficiaries or

owners. WT is required to act as a withholding foreign trust for all such amounts paid to WT, or included in WT's distributive share, by any withholding agent to which WT has provided a Form W-8IMY that represents that WT is acting as a withholding foreign trust with respect to such amounts. WT must act as a withholding foreign trust for any such amounts paid with respect to such a Form W-8IMY that are distributed to, or included in the distributive shares of, its direct foreign beneficiaries or owners. WT may act as a withholding foreign trust for such amounts that are distributed to, or included in the distributive shares of, its direct beneficiaries or owners that are U.S. persons. WT may also act as a withholding foreign trust and may treat itself as a direct foreign beneficiary if (i) WT is a trust the terms of which described in section 651(a)(1) and (2) of the Code and (ii) in any taxable year, WT distributes amounts other than amounts of income described in section 651(a)(1). In no event may WT act as a withholding foreign trust for amounts subject to NRA withholding that are distributed to, or included in the distributive shares of, passthrough beneficiaries or owners or indirect beneficiaries or owners. For passthrough beneficiaries or owners and indirect beneficiaries or owners, WT must act as a nonwithholding foreign trust.

Sec. 1.02. Parties to the Agreement. This Agreement applies to WT and the IRS.

SECTION 2. DEFINITIONS

For purposes of this Agreement, the terms listed below are defined as follows:

Sec. 2.01. Agreement. "Agreement" means this Agreement between WT and the IRS. All appendices to this Agreement and WT's application to become a withholding foreign trust are incorporated into this Agreement by reference.

Sec. 2.02. Amounts Subject to NRA Withholding. An "amount subject to NRA withholding" is an amount described in Treas. Reg. § 1.1441–2(a). An amount subject to NRA withholding shall not include interest paid as part of the purchase price of an obligation sold between interest payment dates or original issue discount paid as part of the purchase price of an obligation sold in a transaction other than the redemption of such obligation, unless the sale is part of a plan the principal purpose of which is to avoid tax and WT has actual knowledge or reason to know of such plan.

Sec. 2.03. Chapter 3 of the Code. Any reference to "chapter 3 of the Code" means sections 1441, 1442, 1443, 1461, 1463, and 1464 of the Code.

Sec. 2.04. Chapter 61 of the Code. Any reference to "chapter 61 of the Code" means sections 6041, 6042, 6045, 6048, 6049, and 6050N of the Code.

Sec. 2.05. Distributive share. "Distributive share" means an amount subject to withholding that is required to be distributed to the beneficiaries of a simple trust and an amount subject to withholding that is includable in the income of the owners of a grantor trust.

Sec. 2.06. External Auditor. An "external auditor" is any approved auditor listed in Appendix A of this Agreement that WT engages to perform the audits required by section 8 of this Agreement.

Sec. 2.07. Flow-Through Entity. A flow-through entity is a foreign partnership described in Treas. Reg. § 301.7701–2 or 3 (other than a withholding foreign partnership), a foreign trust that is described in section 651(a) of the Code, or a foreign trust all or a portion of which is treated as owned by the grantor or other person under sections 671 through 679 of the Code (other than a withholding foreign trust). For an item of income for which a treaty benefit is claimed, an entity is also a flow-through entity to the extent it is treated as fiscally transparent under section 894 and the regulations thereunder.

Sec. 2.08. Foreign Person. A "foreign person" is any person that is not a "United States person" and includes a "nonresident alien individual," a "foreign corporation," a "foreign partnership," a "foreign trust," and a "foreign estate," as those terms are defined in section 7701 of the Code.

Sec. 2.09. Form W-8. "Form W-8" means a valid IRS Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*; IRS Form W-8ECI, *Certificate of Foreign Person's Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States*; IRS Form W-8EXP, *Certificate of Foreign Governments and Other Foreign Organizations for United States Tax Withholding*; and IRS Form W-8IMY, *Certificate of Foreign Intermediary, Foreign Partnership, and Certain U.S. Branches for United States Tax Withholding*, as appropriate. It also includes any acceptable substitute form.

Sec. 2.10. Form W-9. "Form W-9" means a valid IRS Form W-9, *Request for Taxpayer Identification Number and Certification*, or any acceptable substitute.

Sec. 2.11. Form 1042. "Form 1042" means an IRS Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*.

Sec. 2.12. Form 1042-S. "Form 1042-S" means an IRS Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*.

Sec. 2.13. Form 3520. "Form 3520" means an IRS Form 3520, *Annual Return to Report Transaction With Foreign Trust and Receipt of Certain Foreign Gifts*.

Sec. 2.14. Form 3520-A. "Form 3520-A" means an IRS Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*.

Sec. 2.15. Intermediary. An "intermediary" means any person that acts on behalf of another person, such as a custodian, broker, nominee, or other agent.

Sec. 2.16. Nonwithholding Foreign Trust. A "nonwithholding foreign trust" is any foreign trust that is not acting as a withholding foreign trust.

Sec. 2.17. NRA Withholding. For purposes of this agreement "nonresident alien (NRA) withholding" is any withholding required under chapter 3 of the Code (other than sections 1445 or 1446), whether the payment subject to withholding is made to an individual or to an entity.

Sec. 2.18. Overwithholding. The term "overwithholding" means the excess of the amount actually withheld over the amount required to be withheld under chapter 3 of the Code.

Sec. 2.19. Trust, Beneficiary and Owner. The term "trust" is defined in Treas. Reg. § 301.7701–4. The term "beneficiary" is defined in section 643(c) of the Code and the regulations thereunder. An "owner" is a person treated as a grantor or owner under Subpart C of Subchapter J of the Code. A direct beneficiary or owner is a beneficiary or owner,

other than an intermediary or flow-through entity that is not itself a withholding foreign trust or withholding foreign partnership, for which WT acts as a withholding foreign trust. An indirect beneficiary or owner is a person that owns a trust interest in WT though one or more passthrough beneficiaries or owners. A passthrough beneficiary or owner is a direct or indirect beneficiary or owner in WT that is an intermediary or flow-through entity. As provided in Section 2.07 of this Agreement, a withholding foreign partnership or withholding foreign trust is not a flow-through entity and thus is not a passthrough beneficiary or owner.

Sec. 2.20. Payment. A "payment" is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. See Treas. Reg. § 1.1441–2(e).

Sec. 2.21. Reduced Rate of Withholding. A "reduced rate of withholding" means a rate of withholding that is less than 30 percent, either as a result of a reduction in withholding under the Code or as a result of a reduction in withholding under an income tax treaty.

Sec. 2.22. Reportable Amount. A "reportable amount" means an amount subject to NRA withholding (as defined in section 2.02 of this Agreement); U.S. source deposit interest; and U.S. source interest or original issue discount paid on the redemption of short-term obligations. The term does not include payments on deposits with banks and other financial institutions that remain on deposit for two weeks or less. It also does not include amounts of original issue discount arising from a sale and repurchase transaction completed within a period of two weeks or less, or amounts described in Treas. Reg. § 1.6049–5(b)(7), (10), or (11) (relating to certain foreign targeted registered obligations and certain obligations issued in bearer form).

Sec. 2.23. Reporting Pool. A "reporting pool" is defined in section 5.03 of this Agreement.

Sec. 2.24. TIN. A "TIN" is a U.S. taxpayer identification number.

Sec. 2.25. Underwithholding. "Underwithholding" means the excess of the amount required to be withheld under chapter 3 of the Code over the amount actually withheld.

Sec. 2.26. U.S. Person. A "United States (or U.S.) person" is a person described in section 7701(a)(30) of the Code, the U.S. government (including an agency or instrumentality thereof), a State of the United States (including an agency or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof).

Sec. 2.27. Withholding Agent. A "withholding agent" has the same meaning as set forth in Treas. Reg. § 1.1441–7(a) and includes a payor. As used in this Agreement, the term generally refers to the person making a payment to a withholding foreign trust.

Sec. 2.28. Withholding Foreign Trust (or WT). A "withholding foreign trust" is a person, described in Treas. Reg. § 1.1441–5(e)(5)(v), that has entered into a withholding agreement with the IRS to be treated as a withholding foreign trust and is acting in its capacity as a withholding foreign trust.

Sec. 2.29. Withholding Foreign Trust (or WT) EIN. A "withholding foreign trust EIN" or "WT-EIN" means the employer identification number assigned by the IRS to a withholding foreign trust. WT's WT-EIN is only to be used when WT is acting as a withholding foreign trust. For example, WT must give a withholding agent its non-WT EIN, if any, rather than its WT-EIN, if it is not acting as a withholding foreign trust and a taxpayer identification number is required.

Sec. 2.30. Withholding Statement. The term "withholding statement" is defined in section 5.02 of this Agreement.

Sec. 2.31. Other Terms. Any term not defined in this section has the same meaning that it has under the Code, the income tax regulations under the Code, or any applicable income tax treaty.

SECTION 3. WITHHOLDING RESPONSIBILITY

Sec. 3.01. NRA Withholding Responsibility. WT is subject to the withholding and reporting provisions applicable to withholding agents under chapter 3 of the Code. Under chapter 3, a withholding agent must withhold 30 percent of any payment of an amount subject to NRA withholding made to a beneficiary or owner that is a foreign person unless the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a payee that is a U.S. person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding. When it is acting as a withholding foreign trust, WT must assume NRA withholding responsibility for amounts subject to NRA withholding that are distributed to, or included in the distributive share of, any direct beneficiary or owner, and WT must withhold the amount required to be withheld under chapter 3 of the Code. WT must provide a Form W-8IMY that certifies to a withholding agent that makes a payment of such amounts that WT is acting as a withholding foreign trust, and WT must identify such amounts on the withholding statement associated with that Form W-8IMY. WT is not required to withhold when it pays such amounts to another withholding foreign trust or withholding foreign partnership that has certified to WT on Form W-8IMY that it is acting as a withholding foreign trust or withholding foreign partnership with respect to such identified amounts. WT is not required to act as a withholding foreign trust for all amounts that it receives from a withholding agent. WT may not act as a withholding foreign trust for amounts distributed to, or included in the distributive share of, passthrough beneficiaries or owners or indirect beneficiaries or owners. WT must act as a nonwithholding foreign trust for such amounts. When WT is not acting as a withholding foreign trust, WT must: 1) provide to the withholding agent a Form W-8IMY with Part VI completed; 2) identify such amounts on the withholding statement associated with that Form W-8IMY; and 3) provide the documentation and information required by Treas. Reg. §1.1441–5(e)(5)(iii) and (iv).

Sec. 3.02. Timing of Withholding. WT must withhold on the date it makes a distribution to a direct foreign beneficiary or owner that includes an amount subject to NRA withholding. To the extent a direct foreign beneficiary's or owner's distributive share of income subject to withholding has not actually been distributed to the direct foreign beneficiary or owner, WT must withhold on the direct beneficiary's or owner's distributive share on the earlier of the date the statement required under section 6048 is mailed or otherwise provided to the beneficiary or owner or the due date for furnishing the statement (whether or not WT is required to prepare and furnish the statement).

Sec. 3.03. Deposit Requirements. WT must deposit amounts withheld under chapter 3 of the Code with a Federal Reserve bank or authorized financial institution at the time and in the manner provided under section 6302 of the Code (see Treas. Reg. §§ 1.6302–2(a) or 31.6302–1(h)).

SECTION 4. DOCUMENTATION REQUIREMENTS

Sec. 4.01. Documentation Requirements. WT agrees to obtain, review, and maintain Forms W-8 and W-9 in accordance with this section 4. WT must obtain a Form W-8 or W-9 from every direct beneficiary or owner prior to the time that withholding is required. WT agrees to make documentation (together with any associated withholding statements and other documents or information) available upon request for inspection by WT's external auditor. WT represents that none of the laws to which it is subject prohibits disclosure of the identity of any beneficiary or owner or corresponding beneficiary or owner information to WT's external auditor. WT may rely on the Forms W-8 and W-9 it obtains under this section 4 as the basis for determining its withholding and reporting obligations.

Sec. 4.02. Documentation for Foreign Beneficiaries or Owners. WT may treat a direct beneficiary or owner as a foreign beneficial owner if the direct beneficiary or owner provides a Form W-8 that supports such status. WT may treat a direct beneficiary or owner that has provided a Form W-8 as entitled to a reduced rate of NRA withholding if all the requirements for a reduced rate are met and the Form W-8 provided by the direct beneficiary or owner supports entitlement to a reduced rate. Sections 4.03 through 4.06 of this Agreement describe the specific documentation requirements necessary for obtaining a reduced rate of withholding in certain circumstances.

Sec. 4.03. Treaty Claims. WT may not reduce the rate of withholding based on a direct beneficiary's or owner's claim of treaty benefits unless WT obtains from the beneficiary or owner a Form W-8BEN with Part II of the form properly completed, including the appropriate limitation on benefits and section 894 certifications.

Sec. 4.04. Documentation for International Organizations. WT may not treat a direct beneficiary or owner as an international organization entitled to an exemption from withholding under section 892 of the Code unless WT obtains a Form W-8EXP from the international organization and the name provided on the Form W-8EXP is the name of an entity designated as an international organization by executive order pursuant to 22 United States Code 288 through 288(f). If an international organization is not claiming benefits under section 892 of the Code but under another Code exception, the provisions of sections 4.02 of this Agreement apply rather than the provisions of this section 4.04.

Sec. 4.05. Documentation for Foreign Governments and Foreign Central Banks of Issue.

(A) Documentation For a Foreign Government or Foreign Central Bank of Issue Claiming an Exemption From Withholding Under Section 892 or Section 895. WT may not treat a direct beneficiary or owner as a foreign government or foreign central bank of issue exempt from withholding under section 892 or 895 of the Code unless—

(1) WT receives from the direct beneficiary or owner a Form W-8EXP establishing that the direct beneficiary or owner is a foreign government or foreign central bank of issue;

(2) The income distributed to, or included in the distributive share of, the direct beneficiary or owner is the type of income that qualifies for an exemption from withholding under section 892 or 895; and

(3) WT does not know, or have reason to know, that the direct beneficiary or owner is a controlled commercial entity, that the income owned by the foreign government or foreign central bank of issue is being received from a controlled commercial entity, or that the income is from the disposition of an interest in a controlled commercial entity.

(B) Treaty Exemption. WT may not treat a direct beneficiary or owner as a foreign government or foreign central bank of issue entitled to a reduced rate of withholding under an income tax treaty unless it obtains a Form W-8BEN that, under section 4.03 of this Agreement, is sufficient to obtain a reduced rate of withholding under a treaty.

(C) Other Code Exception. If a foreign government or foreign central bank of issue is not claiming benefits under section 892 or 895 of the Code but under another Code exception (*e.g.*, the portfolio interest exception under sections 871(h) or 881(c) of the Code), the provisions of section 4.02 of this Agreement apply rather than the provisions of this section 4.05.

Sec. 4.06. Documentation for Foreign Tax-Exempt Organizations.

(A) Reduced Rate of Withholding Under Section 501. WT may not treat a direct beneficiary or owner as a foreign organization described under section 501(c) of the Code, and therefore exempt from withholding (or, if the direct beneficiary or owner is a foreign private foundation, subject to withholding at a 4-percent rate under section 1443(b) of the Code) unless WT obtains a valid Form W-8EXP on which Part III of the form is completed.

(B) Treaty Exemption. WT may not treat a direct beneficiary or owner as a foreign organization that is tax exempt, or entitled to a reduced rate of withholding under an income tax treaty unless it obtains a Form W-8BEN from the beneficiary or owner that, under section 4.03 of this Agreement, is sufficient to obtain a reduced rate of withholding under a treaty.

(C) Other Exceptions. If a tax-exempt entity is not claiming a reduced rate of withholding because it is an organization described under section 501(c) of the Code or under an income tax treaty, but is

claiming a reduced rate of withholding under another Code exception, the provisions of section 4.02 of this Agreement apply rather than the provisions of this section 4.06.

Sec. 4.07. Documentation For Passthrough Beneficiaries or Owners. WT shall not act as a withholding foreign trust with respect to an amount subject to withholding distributed to, or included in the distributive share of, a passthrough beneficiary or owner. WT must forward that passthrough beneficiary's or owner's documentation (and associated withholding statement and documentation of indirect beneficiaries or owners) to the withholding agent from whom WT receives the amount subject to withholding. WT may act as a withholding foreign trust for payments made to beneficiaries or owners that are themselves withholding foreign trusts or withholding foreign partnerships.

Sec. 4.08. Documentation For U.S. Exempt Recipients. WT shall not treat a beneficiary or owner as a U.S. exempt recipient unless WT obtains from the beneficiary or owner a Form W-9 on which the beneficiary or owner writes "Exempt" in Part II of the Form.

Sec. 4.09. Documentation for U.S. Non-Exempt Recipients. WT shall not treat a beneficiary or owner as a U.S. non-exempt recipient unless WT obtains a Form W-9 from the beneficiary or owner.

Sec. 4.10. Documentation Validity. WT may not rely on Forms W-8 or W-9 if WT has actual knowledge or reason to know that the information or statements contained in the forms are unreliable or incorrect. Once WT knows, or has reason to know, that a Form W-8 or W-9 provided by a direct beneficiary or owner is unreliable or incorrect, WT must obtain a new Form W-8 or W-9 prior to the time withholding is required.

Sec. 4.11. Documentation Validity Period.

(A) Form W-8. WT may rely on a properly completed Form W-8 until its validity expires under Treas. Reg. § 1.1441–1(e)(4)(ii).

(B) Form W-9. WT may rely on a properly completed Form W-9 as long as it has not been informed by the IRS or another withholding agent that the form is unreliable.

Sec. 4.12. Maintenance and Retention of Documentation.

(A) Maintaining Documentation. WT shall maintain Forms W-8 and W-9 by retaining the original documentation, a certified copy, a photocopy, a microfiche, or by electronic storage or similar means of record retention.

(B) Retention Period. WT shall retain a direct beneficiary's or owner's Form W-8 or W-9 obtained under this section 4 for as long as it may be relevant to the determination of WT's tax liability under this agreement.

SECTION 5. WITHHOLDING FOREIGN TRUST WITHHOLDING CERTIFICATE

Sec. 5.01. WT Withholding Certificate. WT agrees to furnish a withholding foreign trust withholding certificate to each withholding agent from which it receives amounts subject to NRA withholding as a withholding foreign trust. The withholding foreign trust withholding certificate is a Form W-8IMY (or acceptable substitute form) that certifies that WT is acting as a withholding foreign trust, contains WT's WT-EIN, and provides all other information required by the form. WT is not required to disclose, as part of that Form W-8IMY or its withholding statement, any information regarding the identity of a direct beneficiary or owner.

Sec. 5.02. Withholding Statement. WT agrees to provide to each withholding agent from which WT receives amounts subject to NRA withholding as a withholding foreign trust a written statement (the "withholding statement") identifying the amounts for which WT acts as a withholding foreign trust. The statement forms an integral part of the Form W-8IMY. The withholding statement may be provided in any manner, and in any form, to which WT and the withholding agent mutually agree.

Sec. 5.03. Withholding Rate Pools. When it is acting as a withholding foreign trust, WT must assume withholding responsibility for amounts subject to withholding that are distributed to, or included in the distributive shares of, its direct beneficiaries or owners. Accordingly, withholding rate pool information is not required as part of WT's withholding statement.

SECTION 6. TAX RETURN OBLIGATIONS

Sec. 6.01. Form 1042 Filing Requirement.

(A) In general. WT shall file a return on Form 1042, whether or not WT withheld any amounts under chapter 3 of the Code, on or before March 15 of the year following any calendar year in which WT acts as a withholding foreign trust. In addition to the information specifically requested on Form 1042 and the accompanying instructions, WT shall attach a statement setting forth the amounts of any overwithholding or underwithholding adjustments made under Treas. Reg. § 1.1461–2 and sections 7.01 and 7.03 of this Agreement, and an explanation of the circumstances that resulted in the over- or under- withholding.

(B) Extensions for Filing Returns. WT may request an extension of the time for filing Form 1042, or any of the information required to be attached to the form, by submitting Form 2758, *Application for Extension of Time to File Certain Excise, Income, Information, and Other Returns*, on or before the due date of the return. The application must be in writing, properly signed by a duly authorized agent of WT, and shall clearly set forth the following:

(1) The calendar year for which the extension is requested; and

(2) A full explanation of the reason(s) for requesting the extension to assist the IRS in determining the period of extension, if any, that will be granted.

Sec. 6.02. Form 1042-S Reporting: General Rule. Unless WT has made a pooled reporting (PR) election pursuant to section 6.03 of this Agreement, WT is required to file separate Forms 1042-S for each direct beneficiary or owner to whom WT distributes, or in whose distributive share is included, an amount subject to NRA withholding. WT must file separate Forms 1042-S by income code, exemption code, recipient code, and withholding rate. WT must file its Forms 1042-S in the manner required by the regulations under chapter 3 of the Code and the instructions to the form, including any requirement to file the forms magnetically or electronically. Any Form 1042-S required by this section 6 shall be filed on

or before March 15 following the calendar year in which withholding, if any, was required under section 3.02 of this agreement. WT may request an extension of time to file Forms 1042-S by submitting Form 8809, *Request for Extension of Time to File Information Returns*, by the due date of Forms 1042-S in the manner required by Form 8809.

Sec. 6.03. Form 1042-S Reporting: Special Rule for PR Election. If WT has made the PR election pursuant to this section 6.03, WT is not required to file Forms 1042-S for amounts distributed to, or included in the distributive share of, each separate direct beneficiary or owner for whom such reporting would otherwise be required. Instead, WT shall file a separate Form 1042-S for each reporting pool. A reporting pool consists of income that falls within a particular withholding rate and within a particular income code, exemption code, and recipient code as determined on Form 1042-S. WT may use a single recipient code for all reporting pools except for amounts paid to foreign tax-exempt recipients, for which a separate recipient code must be used. For this purpose, a foreign tax-exempt recipient includes any organization that is not subject to NRA withholding and is not liable to tax in its country of residence because it is a charitable organization, a pension fund, or a foreign government. WT must make the PR election at the time this agreement is executed by signing the election statement on the signature page of this agreement. Once made, the PR election remains in effect for the entire term of this agreement beginning on the date the agreement becomes effective and ending on the date of its expiration or termination under section 9 of this Agreement. WT must make a new election for each renewal term of this agreement. If WT makes the PR election, WT cannot revoke it prior to the end of the term for which WT has made the PR election. If WT did not make the PR election at the time this agreement was executed, then WT may make a PR election only by terminating this agreement pursuant to section 9.03 and requesting to enter into a new agreement.

Sec. 6.04. Form 3520–A Filing Requirement. If WT is required to file Form 3520-A under section 6048 of the Code, then WT shall file Form 3520-A and furnish any required statements to U.S. beneficiaries or owners in accordance with the instructions for the form.

Sec. 6.05. Retention of Returns. WT shall retain 1042 and Form 3520-A, if required, for the period of the applicable statute of limitations on assessments and collection under the Code.

SECTION 7. ADJUSTMENTS FOR OVER- AND UNDER-WITHHOLDING; REFUNDS

Sec. 7.01. Adjustments for NRA Overwithholding by WT. WT may make an adjustment for amounts paid to its direct beneficiaries or owners that it has overwithheld under chapter 3 of the Code by applying either the reimbursement or set-off procedures described in this section within the time period prescribed for those procedures.

(A) **Reimbursement Procedure**. WT may repay its beneficiaries or owners for an amount overwithheld and reimburse itself by reducing, by the amount of tax actually repaid to the beneficiaries or owners, the amount of any subsequent deposit of tax required to be made by WT under section 3.03 of this Agreement. For purposes of this section 7.01(A), an amount that is overwithheld shall be applied in order of time to each of WT's subsequent deposit periods in the same calendar year to the extent that the withholding taxes required to be deposited for a subsequent deposit period exceed the amount actually deposited. An amount overwithheld in a calendar year may be applied to deposit periods in the calendar year following the calendar year of overwithholding only if:

(1) WT states on a Form 1042-S, filed by March 15 of the calendar year following the calendar year of overwithholding, the amount of tax withheld and the amount of any actual repayments; and

(2) WT states on a Form 1042, filed by March 15 of the calendar year following the calendar year of overwithholding, that the filing of the Form 1042 constitutes a claim for credit in accordance with Treas. Reg. § 1.6414–1.

(B) **Set-Off Procedure**. WT may repay its beneficiaries or owners by applying the amount overwithheld against any amount which otherwise would be required under chapter 3 of the Code to be withheld by WT before the earlier of March 15 of the calendar year following the calendar year of overwithholding or the date that the Form 1042-S is actually filed with the IRS. For purposes of making a return on Form 1042 or 1042-S for the calendar year of overwithholding, and for purposes of making a deposit of the amount withheld, the reduced amount shall be considered the amount required to be withheld from such income under chapter 3 of the Code.

Sec. 7.02. Collective Credit or Refund Procedures for NRA Overwithholding. If WT has made a PR election and it has overwithheld under chapter 3 of the Code on amounts subject to NRA withholding paid to WT's direct beneficiaries or owners during a calendar year and the amount has not been recovered under the reimbursement or set-off procedures under sections 7.01 of this Agreement, WT may request a credit or refund of the total amount overwithheld by following the procedures of this section 7.02. WT shall follow the procedures set forth under sections 6402 and 6414 of the Code, and the regulations thereunder, to claim the credit or refund. No credit or refund will be allowed after the expiration of the statutory period of limitation for refunds under section 6511 of the Code. WT may use the collective refund procedures under this section 7.02 only if the following conditions are met:

(A) WT must not have issued Forms 1042-S to the direct beneficiaries or owners who were subjected to overwithholding;

(B) WT must submit together with its amended return on which it claims a credit or refund a statement of the reason for the overwithholding;

(C) WT must submit together with its amended return on which it claims a credit or refund a statement that it has repaid the amount of overwithholding to the appropriate direct beneficiaries or owners prior to filing the claim for credit or refund; and

(D) WT must retain a record showing that it repaid the direct beneficiaries or owners the amount of the overwithholding.

Sec. 7.03. Adjustments for NRA Underwithholding. If WT knows that an amount should have been withheld under chapter 3 of the Code from a previous payment to a direct beneficiary or owner

but was not withheld, WT may either withhold from future payments made to the same direct beneficiary or owner or satisfy the tax from the direct beneficiary's or owner's proportionate share of assets over which it has control. The additional withholding or satisfaction of the tax owed may only be made before the due date of the Form 1042 (not including extensions) for the calendar year in which the underwithholding occurred.

Sec. 7.04. NRA Underwithholding after Form 1042 Filed. If, after a Form 1042 has been filed for a calendar year, WT, WT's external auditor, or the IRS determines that, due to WT's failure to carry out its obligations under this Agreement, WT has underwithheld tax for such year, WT shall file an amended Form 1042 to report and pay the underwithheld tax. WT shall pay the underwithheld tax, the interest due on the underwithheld tax, and any applicable penalties, at the time of filing the amended Form 1042. If WT fails to file an amended return, the IRS shall make such return under section 6020 of the Code.

Sec. 7.05. Special Rule Regarding Failure to Deposit Penalties. Solely for purposes of applying section 6656 of the Code (failure to make deposit of taxes), WT will not be considered to have made an underpayment of a deposit of NRA withholding taxes if the conditions of this paragraph are met. The conditions of this paragraph are that—

(**A**) WT makes its deposits within the time (deposit period) required by section 6302 of the Code;

(**B**) The deposit is not less than 90 percent of the aggregate amount of the tax required to be withheld under chapter 3 of the Code during the deposit period applicable to WT; and

(**C**) WT determines the difference between the total amount required to be deposited and the amount actually deposited as of the end of the 3rd, 6th, 9th, and 12th months of the calendar year and the difference is deposited no later than the 15th day of the second following month (*i.e.*, May 15, August 15, November 15 and February 15, respectively). In determining whether there has been an underpayment, reimbursements and set-offs shall be taken into account.

SECTION 8. EXTERNAL AUDIT PROCEDURES

Sec. 8.01. In General. Unless WT requests an IRS audit in lieu of an external audit, the IRS agrees not to conduct an on-site audit of WT with respect to withholding and reporting obligations covered by this Agreement provided that an external auditor designated in Appendix A of this Agreement conducts an audit of WT in accordance with this section 8. WT shall permit the external auditor to have access to all relevant records of WT for purposes of performing the external audit, including information regarding specific beneficiaries or owners. WT shall permit the IRS to communicate directly with the external auditor and to review the audit procedures followed by the external auditor. WT represents that there are no legal prohibitions that prevent the external auditor from examining any information relevant to the external audit to be performed under this section 8 and that there are no legal prohibitions that prevent the IRS from communicating directly with the auditor. WT shall permit the IRS to examine the external auditor's work papers and reports.

Sec. 8.02. Designation of External Auditor. WT's external auditor must be one of the auditors listed in Appendix A of this Agreement, unless WT and the IRS agree, prior to the audit, to substitute another auditor. WT shall not propose an external auditor unless it has a reasonable belief that the auditor is subject to laws, regulations, or rules that impose sanctions for failure to exercise its independence and to perform the audit competently. The IRS has the right to reject a proposed external auditor, or to revoke its acceptance of an external auditor, if the IRS, in its sole discretion, reasonably believes that the auditor is not independent or cannot perform an effective audit under this Agreement.

Sec. 8.03. Timing External Audits: General Rule. Unless WT has made a PR election, WT shall have the external auditor conduct an external audit only at such time and only for such calendar years as the IRS directs.

Sec. 8.04. Timing External Audits: Special Rule for PR Election. If WT has made a PR election, WT shall have the external auditor conduct an audit after the close of every other calendar year that this Agreement is in effect. The auditor shall examine the two previous calendar years. For example, the first audit will occur in the third calendar year that the agreement is in effect and the external auditor will examine calendar years one and two.

Sec. 8.05. Scope of External Audit. The external auditor shall verify whether WT is in compliance with this Agreement by conducting an audit that meets the requirements of this section 8.05. The report, described in section 8.06 of this Agreement, must disclose that the external auditor has, at a minimum, performed the following checks listed in this section 8.05, and set forth how each of those checks was performed and the results of the checks. WT's external auditor is encouraged to contact the IRS at the address set forth in section 10.06 of this Agreement and submit an audit plan (which includes, if relevant, the extent to which the external auditor proposes to rely on WT's internal audit procedures) prior to performing the audit so that the audit may be conducted in the most efficient and least costly manner possible.

(**A**) **Documentation**. The external auditor must review information contained in beneficiary or owner files to determine whether the documentation requirements of section 4 of this Agreement are being met.

(**B**) **Withholding Responsibilities**. The external auditor must—

(**1**) Perform test checks of direct beneficiaries or owners, to verify that WT is withholding the proper amounts.

(**2**) Verify that amounts withheld were timely deposited in accordance with section 3.03 of this Agreement.

(**C**) **Return Filing and Information Reporting**. The external auditor must-

(**1**) Obtain copies of original and amended Forms 1042, and any schedules, statements, or attachments required to be filed with those forms, and determine whether the amounts of income, taxes, and other information reported on those forms are accurate by—

(**i**) Reviewing work papers;

(**ii**) Reviewing Forms W-8IMY, together with the associated withholding statements, that WT has provided to withholding agents;

(**iii**) Reviewing copies of Forms 1042-S that withholding agents have provided WT;

(**iv**) Reviewing account statements from withholding agents;

(**v**) Reviewing correspondence between WT and withholding agents; and

(**vi**) Interviewing personnel responsible for preparing the Form 1042 and the work papers used to prepare those forms.

(**2**) Obtain copies of original and corrected Forms 1042-S and Forms 3520-A together with the work papers used to prepare those forms and determine whether the amounts reported on those forms are accurate by—

(**i**) Reviewing the Forms 1042-S received from withholding agents;

(**ii**) Reviewing a valid sample of earnings statements issued by WT to direct beneficiaries or owners, if any.

(**3**) Thoroughly review the statements attached to amended Forms 1042 filed to claim a refund, ascertain their veracity, and determine the causes of any overwithholding reported and ensure WT did not issue Forms 1042-S to persons whom it included as part of its collective credit or refund.

(**4**) Determine, in the case of collective credits or refunds, that WT repaid the appropriate beneficiaries or owners prior to requesting a collective refund or credit.

(**E**) **Change in Circumstances**. The external auditor must verify that in the course of the audit it has not discovered any significant change in circumstances, as described in section 9.05 (A) or (D) of this Agreement.

Sec. 8.06. External Auditor's Report. Upon completion of the audit of WT, the external auditor shall issue a report, or reports, of audit findings directly to the IRS by sending the original report to the IRS at the address set forth in section 10.06 of this Agreement. This report is due by December 31 following the calendar year being audited, or if that date falls on a Saturday or Sunday, the next U.S. business day. The IRS may, however, upon request by the external auditor, extend the due date of the audit report upon good cause. The report must be in writing, in English, and currency amounts must be stated in U.S. dollars. The report must fully describe the scope of the audit, the methodologies (including sampling techniques) used to determine whether WT is in compliance with the provisions of this Agreement, and the result of each such determination. The report must also specifically address each of the items in section 8.05 of this Agreement.

Sec. 8.07. Expanding Scope and Timing of External Audit. Upon review of the external auditor's report, the IRS may request, and WT must permit, the external auditor to perform additional audit procedures.

SECTION 9. EXPIRATION, TERMINATION AND DEFAULT

Sec. 9.01. Term of Agreement: General Rule. If WT has not made a PR election, this Agreement shall be in effect on ________________ and shall continue in force until terminated under 9.03 or 9.04 of this Agreement.

Sec. 9.02. Term of Agreement: Special Rule for PR Election. If WT has made a PR election, this Agreement shall be in effect on ______________ and shall expire on December 31 of the fifth full calendar year after the year in which this Agreement first takes effect. This Agreement may be renewed for additional terms as provided in section 9.08 of this Agreement.

Sec. 9.03. Termination of Agreement. This Agreement may be terminated by either the IRS or WT prior to the end of its term by delivery of a notice of termination to the other party in accordance with section 10.06 of this Agreement. The IRS, however, shall not terminate the Agreement unless there has been a significant change in circumstances, as defined in section 9.05 of this Agreement, or an event of default has occurred, as defined in section 9.06 of this Agreement, and the IRS determines, in its sole discretion, that the significant change in circumstances or the event of default warrants termination of this Agreement. In addition, the IRS shall not terminate this Agreement in the event of default if WT can establish to the satisfaction of the IRS that all events of default for which it has received notice have been cured within the time period agreed upon. The IRS shall notify WT, in accordance with section 9.07 of this Agreement, that an event of default has occurred and that the IRS intends to terminate the Agreement unless WT cures the default. A notice of termination sent by either party shall take effect on the date specified in the notice.

Sec 9.04. Automatic Termination of Agreement. Notwithstanding Section 9.03 of this Agreement, this Agreement will terminate automatically in the event that the external auditor or the IRS discovers that WT was not in possession of Forms W-8 or W-9, as applicable, for any direct beneficiary or owner at any time that withholding or reporting was required under section 3.02 of this agreement. The automatic termination will be effective as of December 31 of the year in which the external auditor or the IRS makes such discovery. This Agreement will be reinstated, effective the same date it was automatically terminated, if WT obtains appropriate Forms W-8 or W-9 (that relate to the time withholding or reporting was required) for each such partner before January 31 of the year following the year in which the agreement automatically terminated. In the event of automatic termination of this agreement, WT must pay any underwithholding of tax, interest, and penalties that the IRS determines is attributable to each undocumented direct beneficiary or owner for the period during which the beneficiary or owner was undocumented, and, if WT has made a PR election, WT must file beneficiary or owner specific Forms 1042-S for every foreign direct beneficiary or owner from the earliest time the Forms W-8 or W-9 were required for any undocumented direct beneficiary or owner through the date of termination. After the date of automatic termination of this agreement, WT may not act as a withholding foreign trust, and must so notify any persons to which WT has furnished a withholding foreign trust certificate. After the date of automatic termination of this agreement, the IRS may reinstate this agreement (or the IRS may require WT to enter into a new withholding foreign trust agreement) on such terms and conditions and with such modifications as the IRS may determine.

Sec. 9.05. Significant Change in Circumstances. For purposes of this Agreement, a significant change in circumstances includes, but is not limited to—

(**A**) A change in U.S. federal law or policy, or applicable foreign law or policy, that affects the validity of any provision of this Agreement, materially

affects the procedures contained in this Agreement, or affects WT's ability to perform its obligations under this Agreement;

(B) A ruling of any court that affects the validity of any provision of this Agreement; or

(C) A significant change in WT's business practices that affects WT's ability to meet its obligations under this Agreement.

Sec. 9.06. Events of Default. For purposes of this Agreement, an event of default occurs if WT fails to perform any material duty or obligation required under this Agreement, and includes, but is not limited to, the occurrence of any of the following:

(A) WT fails to implement adequate procedures, accounting systems, and internal controls to ensure compliance with this Agreement;

(B) WT underwithholds an amount that WT is required to withhold under chapter 3 of the Code and fails to correct the underwithholding or to file an amended Form 1042 reporting, and paying, the appropriate tax;

(C) WT makes excessive refund claims;

(D) WT fails to file Forms 1042, 1042-S, 3520-A (if required), 1041 (if required), and Schedules K-1 (if required) by the due date specified on such forms or files forms or schedules that are materially incorrect or fraudulent;

(E) WT fails to have an external audit performed when required, WT's external auditor fails to provide its report directly to the IRS on a timely basis, WT fails to cooperate with the external auditor, or WT or its external auditor fails to cooperate with the IRS;

(F) WT fails to inform the IRS within 90 days of any significant change in its business practices to the extent that change affects WT's obligations under this Agreement;

(G) WT fails to cure a default identified by the IRS or by an external auditor;

(H) WT makes any fraudulent statement or a misrepresentation of material fact with regard to this Agreement to the IRS, a withholding agent, or WT's external auditor;

(I) The IRS determines that WT's external auditor is not sufficiently independent to adequately perform its audit function or the external auditor fails to provide an audit report that complies with section 8 of this Agreement;

(J) WT is prohibited by any law from disclosing the identity of a beneficiary or owner or beneficiary or owner information to WT's external auditor;

(K) WT fails to make deposits in the time and manner required by section 3.03 of this Agreement or fails to make adequate deposits, taking into account the procedures of 7.05 of this Agreement; or

(L) WT fails to permit the external auditor to perform additional audit procedures under the provisions of section 8.07 of this Agreement.

Sec. 9.07. Notice and Cure. Upon the occurrence of an event of default, the IRS may deliver to WT a notice of default specifying the event of default that has occurred. WT shall respond to the notice of default within 60 days (60-day response) from the date of the notice of default. The 60-day response shall contain an offer to cure the event of default and the time period in which the cure will be accomplished or shall state the reasons why WT does not agree that an event of default has occurred. If WT does not provide a 60-day response, the IRS may deliver a notice of termination as provided in section 9.03 of this Agreement. If WT provides a 60-day response, the IRS shall either accept or reject WT's statement that no default has occurred or accept or reject WT's proposal to cure an event of default. If the IRS rejects WT's contention that no default has occurred or rejects WT's proposal to cure a default, the IRS will offer a counter-proposal to cure the event of default. Within 30 days of receiving the IRS's counter-proposal, WT shall notify the IRS (30-day response) whether it continues to maintain that no default has occurred or whether it rejects the IRS's counter-proposal to cure an event of default. If WT's 30-day response states that no default has occurred or it rejects the IRS's counter-proposal to cure, the parties shall seek to resolve their disagreement within 30 days of the IRS's receipt of WT's 30-day response. If a satisfactory resolution has not been achieved at the end of this latter 30-day period, or if WT fails to provide a 30-day response, the IRS may terminate this Agreement by providing a notice of termination in accordance with section 9.03 of this Agreement. If WT receives a notice of termination from the IRS, it may appeal the determination within 30 days of the date of the notice of termination by sending a written notice to the address specified in section 10.06 of this Agreement. If WT appeals the notice of termination, this Agreement shall not terminate until the appeal has been decided. If an event of default is discovered in the course of an external audit, the WT may cure the default, without following the procedures of this section 9.07, if the external auditor's report describes the default and the actions that WT took to cure the default and the IRS determines that the cure procedures followed by WT were sufficient. If the IRS determines that WT's actions to cure the default were not sufficient, the IRS shall issue a notice of default and the procedures described in this section 9.07 shall be followed.

Sec. 9.08. Renewal. If WT has made the PR election under section 6.03 of this agreement and intends to renew this Agreement for an additional term, it shall submit an application for renewal to the IRS no earlier than one year and no later than six months prior to the expiration of this Agreement. Any such application for renewal must contain an update of the information provided by WT to the IRS in connection with the application to enter into this Agreement, and any other information the IRS may request in connection with the renewal process. This Agreement shall be renewed only upon the signatures of both WT and the IRS. Either the IRS or WT may seek to negotiate a new withholding foreign trust agreement rather than renew this Agreement.

SECTION 10. MISCELLANEOUS PROVISIONS

Sec. 10.01. WT's application to become a withholding foreign trust and the Appendix to this Agreement are hereby incorporated into and made an integral part of this Agreement. This Agreement, WT's application, and the Appendix to this Agreement constitute the complete agreement between the parties.

Sec. 10.02. This Agreement may be amended by the IRS if the IRS determines that such amendment is needed for the sound administration of the internal

revenue laws or internal revenue regulations. The agreement may also be modified by either WT or the IRS upon mutual agreement. Such amendments or modifications shall be in writing.

Sec. 10.03. Any waiver of a provision of this Agreement is a waiver solely of that provision. The waiver does not obligate the IRS to waive other provisions of this Agreement or the same provision at a later date.

Sec. 10.04. This Agreement shall be governed by the laws of the United States. Any legal action brought under this Agreement shall be brought only in a U.S. court with jurisdiction to hear and resolve matters under the internal revenue laws of the United States. For this purpose, WT agrees to submit to the jurisdiction of such U.S. court.

Sec. 10.05. WT's rights and responsibilities under this Agreement cannot be assigned to another person.

Sec. 10.06. Notices provided under this Agreement shall be mailed registered, first class airmail. Notice shall be directed as follows:

To the IRS:

Internal Revenue Service
LMSB:FS:QI
290 Broadway
New York, NY 10007–1867
USA

All notices sent to the IRS must include the WT's WT-EIN.

To WT:

____
____
____
____

Sec. 10.07. WT, acting in its capacity as a withholding foreign trust or in any other capacity, does not act as an agent of the IRS, nor does it have the authority to hold itself out as an agent of the IRS.

IN WITNESS WHEREOF, the above parties have subscribed their names to these presents, in duplicate.

Signed this day of ,

____

(name and title of person signing for WT)

____

(name and title of person signing for IRS)

PR Election Statement

By signing hereunder, WT makes the PR election under section 6.03 of this Agreement.

____

(name and title of person signing for WT)

Appendix A

WT and the IRS agree that any of the following auditors may be used by WT to perform the external audits required by section 8 of this Agreement.
[Names, addresses, telephone and fax numbers of external auditors.]

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26 CFR 601.201: Rulings and determination letters. (Also, Part I, §§ 401; 1.401(a)(9)–1.)

Rev. Proc. 2002–29

SECTION 1. PURPOSE

This revenue procedure provides that qualified retirement plans generally must be amended by the end of the first plan year beginning on or after January 1, 2003, to the extent necessary to comply with final and temporary regulations under § 401(a)(9) of the Internal Revenue Code, relating to required minimum distributions. The revenue procedure contains model plan amendments that sponsors of master and prototype (M&P), volume submitter and individually designed plans may adopt to satisfy this requirement. The revenue procedure also provides that determination letter applications filed on or after the first day of the 2003 plan year will be reviewed with respect to whether the form of the plan satisfies the requirements of the final and temporary regulations under § 401(a)(9).

SECTION 2. BACKGROUND

.01 Section 401(a)(9) provides rules for required minimum distributions from plans qualified under § 401(a). The rules also apply to § 403(b) annuity contracts, § 408 IRAs, § 408A Roth IRAs, and § 457 eligible deferred compensation plans.

.02 Proposed regulations (EE–113–82, 1987–2 C.B. 881) under § 401(a)(9) were published in the **Federal Register** on July 27, 1987, 52 FR 28070, and January 17, 2001, 66 FR 3928. The proposed regulations published in 2001 (the § 401(a)(9) 2001 Proposed Regulations) substantially simplified many of the rules in regulations that had been proposed in 1987 (the § 401(a)(9) 1987 Proposed Regulations) and also incorporated other guidance published after 1987, including guidance relating to the changes to § 401(a)(9) made by the Small Business Job Protection Act of 1996, Pub. L. 104–188 (SBJPA).

.03 The preamble to the § 401(a)(9) 2001 Proposed Regulations stated that taxpayers could rely on the § 401(a)(9) 1987 Proposed Regulations or the § 401(a)(9) 2001 Proposed Regulations for determining required minimum distributions for calendar year 2001 and subsequent calendar years prior to the effective date of the final regulations. The preamble also contained a model amendment that sponsors of qualified plans could adopt if they wished to apply the § 401(a)(9) 2001 Proposed Regulations in making all required minimum distributions for 2001 and subsequent calendar years prior to the effective date of the final regulations. After publication in the **Federal Register**, the model amendment was republished in Announcement 2001–18, 2001–1 C.B. 791, with minor corrections, and appeared (as corrected in the I.R.B.) in the preamble to the § 401(a)(9) 2001 Proposed Regulations (REG–130477–00; REG–130481–00, 2001–1 C.B. 865).

.04 An alternative model amendment was published in Announcement 2001–82, 2001–32 I.R.B. 123. This additional model amendment was provided in response to the concerns of qualified plan sponsors that intended to use the § 401(a)(9) 2001 Proposed Regulations for distributions for 2001 but made required minimum distributions for 2001 under the § 401(a)(9) 1987 Proposed Regulations prior to the date in 2001 on which the plan began operating under the § 401(a)(9) 2001 Proposed Regulations. The alternative model amendment in Announcement 2001–82 allowed required minimum distributions made for 2001 prior to the date in 2001 on which the

plan began operating under the § 401(a)(9) 2001 Proposed Regulations to be made under the § 401(a)(9) 1987 Proposed Regulations.

.05 The alternative model amendment in Announcement 2001–82 provided the following rules with respect to distributees who received 2001 required distributions prior to the date in 2001 on which the plan began operating under the § 401(a)(9) 2001 Proposed Regulations. If the total amount of 2001 required minimum distributions made to a participant prior to the date on which the plan began operating in accordance with the § 401(a)(9) 2001 Proposed Regulations equaled or exceeded the required minimum distributions determined under the § 401(a)(9) 2001 Proposed Regulations, then no additional distributions were required for that participant for 2001 on or after such date. If the total amount of 2001 required minimum distributions made to a participant prior to the date on which the plan began operating in accordance with the § 401(a)(9) 2001 Proposed Regulations was less than the amount determined under the § 401(a)(9) 2001 Proposed Regulations, then required minimum distributions for 2001 on and after such date would be determined so that the total amount of required minimum distributions for 2001 for that participant would be the amount determined under the § 401(a)(9) 2001 Proposed Regulations.

.06 In order for a qualified plan sponsor to use either the original model amendment in Announcement 2001–18 or the alternative model amendment in Announcement 2001–82, the plan sponsor was required to adopt the amendment by the deadline for amending its plan for GUST. See Rev. Proc. 2001–55, 2001–49 I.R.B. 552.

.07 Final and temporary regulations (T.D. 8987, 2002–19 I.R.B. 852) under § 401(a)(9) were published in the Federal Register on April 17, 2002, 74 FR 18987 (the § 401(a)(9) Final and Temporary Regulations). The § 401(a)(9) Final and Temporary Regulations generally adopt the simplifications proposed in 2001 and provide additional simplifications. The § 401(a)(9) Final and Temporary regulations apply for determining required minimum distributions for calendar years beginning on or after January 1, 2003. For determining required minimum distributions for calendar year 2002, taxpayers may rely on the § 401(a)(9) Final and Temporary Regulations, the § 401(a)(9) 2001 Proposed Regulations, or the § 401(a)(9) 1987 Proposed Regulations.

.08 Section 401(b) and the regulations thereunder provide a remedial amendment period during which an amendment to a disqualifying provision may be made retroactively effective, under certain circumstances, to comply with the requirements of § 401(a). Section 1.401(b)–1(b) provides that a disqualifying provision includes an amendment to an existing plan that causes the plan to fail to satisfy the requirements of § 401(a). Notice 2001–42, 2001–30 I.R.B. 70, provides a remedial amendment period under § 401(b) ending not prior to the last day of the first plan year beginning on or after January 1, 2005, in which any needed retroactive amendment with regard to the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107–16, (EGTRRA), may be adopted. The availability of this remedial amendment period is conditioned on the adoption of a good faith EGTRRA plan amendment no later than the later of: (i) the end of the plan year in which the EGTRRA change in the qualification requirement is required to be, or is optionally, put into effect under the plan; or (ii) the end of the GUST remedial amendment period for the plan.

.09 Rev. Proc. 2000–20, 2000–1 C.B. 553, as modified by Rev. Proc. 2000–27, 2000–1 C.B. 1272, Notice 2001–42, 2001–30 I.R.B. 70, and Rev. Proc. 2001–55, contains the Service's procedures for issuing opinion letters regarding the acceptability of the form of M&P plans.

.10 Rev. Proc. 2002–6, 2002–1 I.R.B. 203, contains the Service's procedures for issuing determination letters on the qualified status of employee plans under §§ 401(a), 403(a), 409 and 4975(e)(7) of the Code and the exempt status of related trusts or custodial accounts under § 501(a).

.11 Section 1.401(a)(9)–1, Q&A–3, describes the provisions that a plan must contain in order to satisfy § 401(a)(9). The plan must generally set forth the statutory rules of § 401(a)(9), including the incidental death benefit requirement in § 401(a)(9)(G), and must provide that distributions must be made in accordance with the § 401(a)(9) Final and Temporary Regulations. The plan must provide that its provisions reflecting § 401(a)(9) override any inconsistent distribution options in the plan and must include such other provisions as the Commissioner may prescribe in guidance published in the Internal Revenue Bulletin.

SECTION 3. REQUIRED PLAN AMENDMENTS

.01 In general, qualified plans must be amended by the last day of the first plan year beginning on or after January 1, 2003, to the extent necessary to comply with the requirements of the § 401(a)(9) Final and Temporary Regulations. Whether and the extent to which a particular plan must be amended depends on the plan's current terms. Any plan amendments for the § 401(a)(9) Final and Temporary Regulations must apply in determining required minimum distributions under the plan for calendar years beginning on or after January 1, 2003. If a plan sponsor begins operating its plan under the § 401(a)(9) Final and Temporary Regulations on a date in 2002, then the amendments must also apply in determining required minimum distributions under the plan for 2002 that are made on or after such date, although the amendments are not required to be adopted before the last day of the first plan year beginning on or after January 1, 2003.

.02 If a plan sponsor begins operating its plan under the § 401(a)(9) Final and Temporary Regulations on a date in 2002 and prior to such date the plan sponsor has made required minimum distributions for 2002 under the § 401(a)(9) 1987 Proposed Regulations or the § 401(a)(9) 2001 Proposed Regulations, then the plan must also be amended to provide the transitional rule for 2002 required minimum distributions that is set forth in section 1.2 of the model amendments in the Appendix to this revenue procedure.

.03 Every M&P plan must allow the M&P plan sponsor to amend the plan on behalf of all adopting employers so that changes in the Code, regulations, revenue rulings, other statements published by the Internal Revenue Service, or corrections of prior approved plans may be applied to all employers who have adopted the plan. Therefore, by December 31, 2003, every sponsor of an M&P plan must amend its

plan to the extent necessary to comply with the requirements of the § 401(a)(9) Final and Temporary Regulations and must furnish copies of the amendments to all employers who have adopted the plan. A favorable opinion letter may not be relied upon after December 31, 2003, unless the M&P plan sponsor satisfies this requirement.

.04 Practitioners that sponsor volume submitter plans generally are not authorized to amend the plan on behalf of adopting employers. In this case, employers that have adopted the plan must individually amend their plans by the last day of the first plan year beginning on or after January 1, 2003, to the extent necessary to comply with the requirements of the § 401(a)(9) Final and Temporary Regulations. Nevertheless, volume submitter practitioners must amend their specimen plans for the § 401(a)(9) Final and Temporary Regulations by December 31, 2003, so that the amendments will apply to future adopters of the plan. A favorable advisory letter may not be relied upon after December 31, 2003, unless the volume submitter practitioner satisfies this requirement.

.05 Until further notice, sponsors of pre-approved plans are not required to request opinion or advisory letters that consider whether their plans satisfy the requirements of the § 401(a)(9) Final and Temporary Regulations. However, opinion and advisory letter applications filed on or after January 1, 2003, will be reviewed with respect to whether the form of the plan satisfies these requirements. Opinion and advisory letter applications filed before January 1, 2003, will be reviewed with respect to whether the form of the plan satisfies the requirements of the § 401(a)(9) Final and Temporary Regulations if a plan amendment to comply with the § 401(a)(9) Final and Temporary Regulations is submitted in conjunction with and at the same time as the request for the opinion or advisory letter.

.06 Determination letter applications for individually designed plans filed on or after the first day of the first plan year beginning on or after January 1, 2003, will be reviewed with respect to whether the form of the plan satisfies the requirements of the § 401(a)(9) Final and Temporary Regulations. Determination letter applications for individually designed plans filed before the first day of the first plan year beginning on or after January 1, 2003, will be reviewed with respect to whether the form of the plan satisfies the requirements of the § 401(a)(9) Final and Temporary Regulations if a plan amendment to comply with the § 401(a)(9) Final and Temporary Regulations is submitted in conjunction with and at the same time as the request for the determination letter. In both cases, determination letters issued for such applications may be relied on with respect to the requirements of the § 401(a)(9) Final and Temporary Regulations. Determination letters issued for pre-approved plans may be relied on with respect to the requirements of the § 401(a)(9) Final and Temporary Regulations if those requirements were considered in issuing the opinion or advisory letter.

.07 If a plan is timely amended to comply with the § 401(a)(9) Final and Temporary Regulations and, as a result of the amendment, there is a disqualifying provision under § 401(b), the remedial amendment period with respect to the disqualifying provision will end at the end of the EGTRRA remedial amendment period. Therefore, an application for a determination letter regarding the effect of the plan amendment need not be filed earlier than the last day of the EGTRRA remedial amendment period. The timely adoption of the appropriate model amendment in the Appendix will provide reliance, without the need to request a letter, that the plan has been amended to comply with the § 401(a)(9) Final and Temporary Regulations and will not result in a disqualifying provision.

.08 The Appendix provides two model plan amendments to facilitate the amendment of qualified plans to comply with the requirements of the § 401(a)(9) Final and Temporary Regulations. The model amendments may be adopted by M&P plans sponsors and volume submitter practitioners and also by sponsors of individually designed plans. The model amendments are "snap-on" amendments designed to work with a plan's existing minimum distribution provisions by superseding those that are inconsistent with the provisions of the model amendment and retaining those (such as the plan's definition of required beginning date) that are not inconsistent. Plans that are amended to adopt the model amendments must retain their existing required minimum distribution provisions in order to have reliance that the form of the plan has been properly amended to comply with the § 401(a)(9) Final and Temporary Regulations. Adoption of one of the model amendments will not amend a plan for the changes to § 401(a)(9) made by § 1404 of SBJPA or to provide that 2001 or 2002 required minimum distributions will be determined in accordance with the § 401(a)(9) 2001 Proposed Regulations.

The first model amendment is for defined contribution plans. The second model amendment is for defined benefit plans. A plan sponsor or a sponsor of a pre-approved plan that timely adopts the appropriate model amendment verbatim (or with only minor changes) will have reliance that the form of its plan satisfies the requirements of the § 401(a)(9) Final and Temporary Regulations, and the adoption of the model amendment will not adversely affect the plan sponsor's reliance on a favorable determination, opinion or advisory letter, or cause a pre-approved plan to be treated as an individually designed plan. For this purpose, changes to either of the model amendments to incorporate the adoption agreement elective provisions into the body of the amendment or to remove the elective provisions in favor of the default rules in the body of the amendment are minor changes.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2000–20 and Rev. Proc. 2002–6 are modified.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective June 17, 2002.

DRAFTING INFORMATION

The principal authors of this revenue procedure are James Flannery and Steven Linder of Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue procedure, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 between the hours of 8:00 a.m. and 6:30 p.m. Eastern

time, Monday through Friday (a toll-free number). Mr. Flannery and Mr. Linder may be reached at 1–202–283–9888 (not a toll-free call).

APPENDIX — MODEL AMENDMENTS

The following are model plan amendments that sponsors of pre-approved plans and sponsors of individually designed plans may adopt to comply with the § 401(a)(9) Final and Temporary Regulations. Except as provided below, a plan that is amended to adopt one of the model amendments will satisfy, in form, the requirements of § 401(a)(9) and the § 401(a)(9) Final and Temporary Regulations in determining required minimum distributions for calendar years beginning on or after January 1, 2003 (as well as required minimum distributions for calendar year 2002 made on or after the date the plan sponsor begins to operate its plan in accordance with the § 401(a)(9) Final and Temporary Regulations). Adoption of the model amendments will not amend a plan to reflect the change to the definition of required beginning date in § 401(a)(9)(C) that was made by § 1404 of SBJPA or to provide the actuarial adjustment that may be required in a defined benefit plan that is so amended. A plan sponsor that wishes to amend its plan to reflect the provisions of § 1404 of SBJPA must do so through a separate amendment. Consequently, the model amendments may not be relied upon with respect to whether a plan's definition of required beginning date is correct or whether a defined benefit plan makes the correct actuarial adjustment required by § 401(a)(9)(C)(iii). Adoption of the model amendments also will not amend a plan to provide that 2001 or 2002 required minimum distributions will be determined in accordance with the § 401(a)(9) 2001 Proposed Regulations. A plan sponsor that has operated its plan in accordance with the § 401(a)(9) 2001 Proposed Regulations must adopt the model amendment in Announcement 2001–18 or the alternative model amendment in Announcement 2001–82 within the plan's GUST remedial amendment period. Plans that are amended to adopt the model amendments must retain their existing required minimum distribution provisions in order to have reliance that the form of the plan has been properly amended to comply with the § 401(a)(9) Final and Temporary Regulations.

MODEL PLAN AMENDMENT 1 — DEFINED CONTRIBUTION PLANS

Article _______. MINIMUM DISTRIBUTION REQUIREMENTS.

Section 1. General Rules

1.1. Effective Date. Unless an earlier effective date is specified in the adoption agreement, the provisions of this article will apply for purposes of determining required minimum distributions for calendar years beginning with the 2003 calendar year.

1.2. Coordination with Minimum Distribution Requirements Previously in Effect. If the adoption agreement specifies an effective date of this article that is earlier than calendar years beginning with the 2003 calendar year, required minimum distributions for 2002 under this article will be determined as follows. If the total amount of 2002 required minimum distributions under the plan made to the distributee prior to the effective date of this article equals or exceeds the required minimum distributions determined under this article, then no additional distributions will be required to be made for 2002 on or after such date to the distributee. If the total amount of 2002 required minimum distributions under the plan made tc the distributee prior to the effective date of this article is less than the amount determined under this article, then required minimum distributions for 2002 on and after such date will be determined so that the total amount of required minimum distributions for 2002 made to the distributee will be the amount determined under this article.

1.3. Precedence. The requirements of this article will take precedence over any inconsistent provisions of the plan.

1.4. Requirements of Treasury Regulations Incorporated. All distributions required under this article will be determined and made in accordance with the Treasury regulations under section 401(a)(9) of the Internal Revenue Code.

1.5. TEFRA Section 242(b)(2) Elections. Notwithstanding the other provisions of this article, distributions may be made under a designation made before January 1, 1984, in accordance with section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act (TEFRA) and the provisions of the plan that relate to section 242(b)(2) of TEFRA.

Section 2. Time and Manner of Distribution.

2.1. Required Beginning Date. The participant's entire interest will be distributed, or begin to be distributed, to the participant no later than the participant's required beginning date.

2.2. Death of Participant Before Distributions Begin. If the participant dies before distributions begin, the participant's entire interest will be distributed, or begin to be distributed, no later than as follows:

(a) If the participant's surviving spouse is the participant's sole designated beneficiary, then, except as provided in the adoption agreement, distributions to the surviving spouse will begin by December 31 of the calendar year immediately following the calendar year in which the participant died, or by December 31 of the calendar year in which the participant would have attained age 70½, if later.

(b) If the participant's surviving spouse is not the participant's sole designated beneficiary, then, except as provided in the adoption agreement, distributions to the designated beneficiary will begin by December 31 of the calendar year immediately following the calendar year in which the participant died.

(c) If there is no designated beneficiary as of September 30 of the year following the year of the participant's death, the participant's entire interest will be distributed by December 31 of the calendar year containing the fifth anniversary of the participant's death.

(d) If the participant's surviving spouse is the participant's sole designated beneficiary and the surviving spouse dies after the participant but before distributions to the surviving spouse begin, this section 2.2, other than section 2.2(a), will apply as if the surviving spouse were the participant.

For purposes of this section 2.2 and section 4, unless section 2.2(d) applies, distributions are considered to begin on the participant's required beginning date. If section 2.2(d) applies, distributions are

considered to begin on the date distributions are required to begin to the surviving spouse under section 2.2(a). If distributions under an annuity purchased from an insurance company irrevocably commence to the participant before the participant's required beginning date (or to the participant's surviving spouse before the date distributions are required to begin to the surviving spouse under section 2.2(a)), the date distributions are considered to begin is the date distributions actually commence.

2.3. Forms of Distribution. Unless the participant's interest is distributed in the form of an annuity purchased from an insurance company or in a single sum on or before the required beginning date, as of the first distribution calendar year distributions will be made in accordance with sections 3 and 4 of this article. If the participant's interest is distributed in the form of an annuity purchased from an insurance company, distributions thereunder will be made in accordance with the requirements of section 401(a)(9) of the Code and the Treasury regulations.

Section 3. Required Minimum Distributions During Participant's Lifetime.

3.1. Amount of Required Minimum Distribution For Each Distribution Calendar Year. During the participant's lifetime, the minimum amount that will be distributed for each distribution calendar year is the lesser of:

(a) the quotient obtained by dividing the participant's account balance by the distribution period in the Uniform Lifetime Table set forth in section 1.401(a)(9)–9 of the Treasury regulations, using the participant's age as of the participant's birthday in the distribution calendar year; or

(b) if the participant's sole designated beneficiary for the distribution calendar year is the participant's spouse, the quotient obtained by dividing the participant's account balance by the number in the Joint and Last Survivor Table set forth in section 1.401(a)(9)–9 of the Treasury regulations, using the participant's and spouse's attained ages as of the participant's and spouse's birthdays in the distribution calendar year.

3.2. Lifetime Required Minimum Distributions Continue Through Year of Participant's Death. Required minimum distributions will be determined under this section 3 beginning with the first distribution calendar year and up to and including the distribution calendar year that includes the participant's date of death

Section 4. Required Minimum Distributions After Participant's Death.

4.1. Death On or After Date Distributions Begin.

(a) Participant Survived by Designated Beneficiary. If the participant dies on or after the date distributions begin and there is a designated beneficiary, the minimum amount that will be distributed for each distribution calendar year after the year of the participant's death is the quotient obtained by dividing the participant's account balance by the longer of the remaining life expectancy of the participant or the remaining life expectancy of the participant's designated beneficiary, determined as follows:

(1) The participant's remaining life expectancy is calculated using the age of the participant in the year of death, reduced by one for each subsequent year.

(2) If the participant's surviving spouse is the participant's sole designated beneficiary, the remaining life expectancy of the surviving spouse is calculated for each distribution calendar year after the year of the participant's death using the surviving spouse's age as of the spouse's birthday in that year. For distribution calendar years after the year of the surviving spouse's death, the remaining life expectancy of the surviving spouse is calculated using the age of the surviving spouse as of the spouse's birthday in the calendar year of the spouse's death, reduced by one for each subsequent calendar year.

(3) If the participant's surviving spouse is not the participant's sole designated beneficiary, the designated beneficiary's remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the participant's death, reduced by one for each subsequent year.

(b) No Designated Beneficiary. If the participant dies on or after the date distributions begin and there is no designated beneficiary as of September 30 of the year after the year of the participant's death, the minimum amount that will be distributed for each distribution calendar year after the year of the participant's death is the quotient obtained by dividing the participant's account balance by the participant's remaining life expectancy calculated using the age of the participant in the year of death, reduced by one for each subsequent year.

4.2. Death Before Date Distributions Begin.

(a) Participant Survived by Designated Beneficiary. Except as provided in the adoption agreement, if the participant dies before the date distributions begin and there is a designated beneficiary, the minimum amount that will be distributed for each distribution calendar year after the year of the participant's death is the quotient obtained by dividing the participant's account balance by the remaining life expectancy of the participant's designated beneficiary, determined as provided in section 4.1.

(b) No Designated Beneficiary. If the participant dies before the date distributions begin and there is no designated beneficiary as of September 30 of the year following the year of the participant's death, distribution of the participant's entire interest will be completed by December 31 of the calendar year containing the fifth anniversary of the participant's death.

(c) Death of Surviving Spouse Before Distributions to Surviving Spouse Are Required to Begin. If the participant dies before the date distributions begin, the participant's surviving spouse is the participant's sole designated beneficiary, and the surviving spouse dies before distributions are required to begin to the surviving spouse under section 2.2(a), this section 4.2 will apply as if the surviving spouse were the participant.

Section 5. Definitions.

5.1. Designated beneficiary. The individual who is designated as the beneficiary under section _______ of the plan and is the designated beneficiary under section 401(a)(9) of the Internal Revenue Code and section 1.401(a)(9)–1, Q&A-4, of the Treasury regulations.

5.2. Distribution calendar year. A calendar year for which a minimum distribution is required. For distributions beginning before the participant's death, the

first distribution calendar year is the calendar year immediately preceding the calendar year which contains the participant's required beginning date. For distributions beginning after the participant's death, the first distribution calendar year is the calendar year in which distributions are required to begin under section 2.2. The required minimum distribution for the participant's first distribution calendar year will be made on or before the participant's required beginning date. The required minimum distribution for other distribution calendar years, including the required minimum distribution for the distribution calendar year in which the participant's required beginning date occurs, will be made on or before December 31 of that distribution calendar year.

5.3. Life expectancy. Life expectancy as computed by use of the Single Life Table in section 1.401(a)(9)–9 of the Treasury regulations.

5.4. Participant's account balance. The account balance as of the last valuation date in the calendar year immediately preceding the distribution calendar year (valuation calendar year) increased by the amount of any contributions made and allocated or forfeitures allocated to the account balance as of dates in the valuation calendar year after the valuation date and decreased by distributions made in the valuation calendar year after the valuation date. The account balance for the valuation calendar year includes any amounts rolled over or transferred to the plan either in the valuation calendar year or in the distribution calendar year if distributed or transferred in the valuation calendar year.

5.5 Required beginning date. The date specified in section _______ of the plan.

Adoption Agreement

(Check and complete section 1 below if any required minimum distributions for the 2002 distribution calendar year were made in accordance with the § 401(a)(9) Final and Temporary Regulations.)

Section 1. Effective Date of Plan Amendment for Section 401(a)(9) Final and Temporary Treasury Regulations.

_______. Article _______, Minimum Distribution Requirements, applies for purposes of determining required minimum distributions for distribution calendar years beginning with the 2003 calendar year, as well as required minimum distributions for the 2002 distribution calendar year that are made on or after _______.

(Check and complete any of the remaining sections if you wish to modify the rules in sections 2.2 and 4.2 of Article _______ of the plan.)

Section 2. Election to Apply 5-Year Rule to Distributions to Designated Beneficiaries.

_______ If the participant dies before distributions begin and there is a designated beneficiary, distribution to the designated beneficiary is not required to begin by the date specified in section 2.2 of Article _____ of the plan, but the participant's entire interest will be distributed to the designated beneficiary by December 31 of the calendar year containing the fifth anniversary of the participant's death. If the participant's surviving spouse is the participant's sole designated beneficiary and the surviving spouse dies after the participant but before distributions to either the participant or the surviving spouse begin, this election will apply as if the surviving spouse were the participant.

This election will apply to:

_______All distributions.
_______The following distributions:
_________________________.

Section 3. Election to Allow Participants or Beneficiaries to Elect 5-Year Rule.

_______ Participants or beneficiaries may elect on an individual basis whether the 5-year rule or the life expectancy rule in sections 2.2 and 4.2 of Article _______ of the plan applies to distributions after the death of a participant who has a designated beneficiary. The election must be made no later than the earlier of September 30 of the calendar year in which distribution would be required to begin under section 2.2 of Article _______ of the plan, or by September 30 of the calendar year which contains the fifth anniversary of the participant's (or, if applicable, surviving spouse's) death. If neither the participant nor beneficiary makes an election under this paragraph, distributions will be made in accordance with sections 2.2 and 4.2 of Article of the plan and, if applicable, the elections in section 2 above.

Section 4. Election to Allow Designated Beneficiary Receiving Distributions Under 5-Year Rule to Elect Life Expectancy Distributions.

_______ A designated beneficiary who is receiving payments under the 5-year rule may make a new election to receive payments under the life expectancy rule until December 31, 2003, provided that all amounts that would have been required to be distributed under the life expectancy rule for all distribution calendar years before 2004 are distributed by the earlier of December 31, 2003, or the end of the 5-year period.

MODEL PLAN AMENDMENT 2 — DEFINED BENEFIT PLANS

Article _______. MINIMUM DISTRIBUTION REQUIREMENTS.

Section 1. General Rules

1.1. Effective Date. Unless an earlier effective date is specified in the adoption agreement, the provisions of this article will apply for purposes of determining required minimum distributions for calendar years beginning with the 2003 calendar year.

1.2. Coordination with Minimum Distribution Requirements Previously in Effect. If the adoption agreement specifies an effective date of this article that is earlier than calendar years beginning with the 2003 calendar year, required minimum distributions for 2002 under this article will be determined as follows. If the total amount of 2002 required minimum distributions under the plan made to the distributee prior to the effective date of this article equals or exceeds the required minimum distributions determined under this article, then no additional distributions will be required to be made for 2002 on or after such date to the distributee. If the total amount of 2002 required minimum distributions under the

plan made to the distributee prior to the effective date of this article is less than the amount determined under this article, then required minimum distributions for 2002 on and after such date will be determined so that the total amount of required minimum distributions for 2002 made to the distributee will be the amount determined under this article.

1.3. Precedence. The requirements of this article will take precedence over any inconsistent provisions of the plan.

1.4. Requirements of Treasury Regulations Incorporated. All distributions required under this article will be determined and made in accordance with the Treasury regulations under section 401(a)(9) of the Internal Revenue Code.

1.5. TEFRA Section 242(b)(2) Elections. Notwithstanding the other provisions of this article, other than section 1.4, distributions may be made under a designation made before January 1, 1984, in accordance with section 242(b)(2) of the Tax Equity and Fiscal Responsibility Act (TEFRA) and the provisions of the plan that relate to section 242(b)(2) of TEFRA.

Section 2. Time and Manner of Distribution.

2.1. Required Beginning Date. The participant's entire interest will be distributed, or begin to be distributed, to the participant no later than the participant's required beginning date.

2.2. Death of Participant Before Distributions Begin. If the participant dies before distributions begin, the participant's entire interest will be distributed, or begin to be distributed, no later than as follows:

(a) If the participant's surviving spouse is the participant's sole designated beneficiary, then, except as provided in the adoption agreement, distributions to the surviving spouse will begin by December 31 of the calendar year immediately following the calendar year in which the participant died, or by December 31 of the calendar year in which the participant would have attained age 70½, if later.

(b) If the participant's surviving spouse is not the participant's sole designated beneficiary, then, except as provided in the adoption agreement, distributions to the designated beneficiary will begin by December 31 of the calendar year immediately following the calendar year in which the participant died.

(c) If there is no designated beneficiary as of September 30 of the year following the year of the participant's death, the participant's entire interest will be distributed by December 31 of the calendar year containing the fifth anniversary of the participant's death.

(d) If the participant's surviving spouse is the participant's sole designated beneficiary and the surviving spouse dies after the participant but before distributions to the surviving spouse begin, this section 2.2, other than section 2.2(a), will apply as if the surviving spouse were the participant.

For purposes of this section 2.2 and section 5, distributions are considered to begin on the participant's required beginning date (or, if section 2.2(d) applies, the date distributions are required to begin to the surviving spouse under section 2.2(a)). If annuity payments irrevocably commence to the participant before the participant's required beginning date (or to the participant's surviving spouse before the date distributions are required to begin to the surviving spouse under section 2.2(a)), the date distributions are considered to begin is the date distributions actually commence.

2.3. Form of Distribution. Unless the participant's interest is distributed in the form of an annuity purchased from an insurance company or in a single sum on or before the required beginning date, as of the first distribution calendar year distributions will be made in accordance with sections 3, 4 and 5 of this article. If the participant's interest is distributed in the form of an annuity purchased from an insurance company, distributions thereunder will be made in accordance with the requirements of section 401(a)(9) of the Code and the Treasury regulations. Any part of the participant's interest which is in the form of an individual account described in section 414(k) of the Code will be distributed in a manner satisfying the requirements of section 401(a)(9) of the Code and the Treasury regulations that apply to individual accounts.

Section 3. Determination of Amount to be Distributed Each Year.

3.1. General Annuity Requirements. If the participant's interest is paid in the form of annuity distributions under the plan, payments under the annuity will satisfy the following requirements:

(a) the annuity distributions will be paid in periodic payments made at intervals not longer than one year;

(b) the distribution period will be over a life (or lives) or over a period certain not longer than the period described in section 4 or 5;

(c) once payments have begun over a period certain, the period certain will not be changed even if the period certain is shorter than the maximum permitted;

(d) payments will either be nonincreasing or increase only as follows:

(1) by an annual percentage increase that does not exceed the annual percentage increase in a cost-of-living index that is based on prices of all items and issued by the Bureau of Labor Statistics;

(2) to the extent of the reduction in the amount of the participant's payments to provide for a survivor benefit upon death, but only if the beneficiary whose life was being used to determine the distribution period described in section 4 dies or is no longer the participant's beneficiary pursuant to a qualified domestic relations order within the meaning of section 414(p);

(3) to provide cash refunds of employee contributions upon the participant's death; or

(4) to pay increased benefits that result from a plan amendment.

3.2. Amount Required to be Distributed by Required Beginning Date. The amount that must be distributed on or before the participant's required beginning date (or, if the participant dies before distributions begin, the date distributions are required to begin under section 2.2(a) or (b)) is the payment that is required for one payment interval. The second payment need not be made until the end of the next payment interval even if that payment interval ends in the next calendar year. Payment intervals are the periods for which payments are received, *e.g.*, bi-monthly, monthly, semi-annually, or annually. All of the participant's benefit

accruals as of the last day of the first distribution calendar year will be included in the calculation of the amount of the annuity payments for payment intervals ending on or after the participant's required beginning date.

3.3. Additional Accruals After First Distribution Calendar Year. Any additional benefits accruing to the participant in a calendar year after the first distribution calendar year will be distributed beginning with the first payment interval ending in the calendar year immediately following the calendar year in which such amount accrues.

Section 4. Requirements For Annuity Distributions That Commence During Participant's Lifetime.

4.1. Joint Life Annuities Where the Beneficiary Is Not the Participant's Spouse. If the participant's interest is being distributed in the form of a joint and survivor annuity for the joint lives of the participant and a nonspouse beneficiary, annuity payments to be made on or after the participant's required beginning date to the designated beneficiary after the participant's death must not at any time exceed the applicable percentage of the annuity payment for such period that would have been payable to the participant using the table set forth in Q&A-2 of section 1.401(a)(9)–6T of the Treasury regulations. If the form of distribution combines a joint and survivor annuity for the joint lives of the participant and a nonspouse beneficiary and a period certain annuity, the requirement in the preceding sentence will apply to annuity payments to be made to the designated beneficiary after the expiration of the period certain.

4.2. Period Certain Annuities. Unless the participant's spouse is the sole designated beneficiary and the form of distribution is a period certain and no life annuity, the period certain for an annuity distribution commencing during the participant's lifetime may not exceed the applicable distribution period for the participant under the Uniform Lifetime Table set forth in section 1.401(a)(9)–9 of the Treasury regulations for the calendar year that contains the annuity starting date. If the annuity starting date precedes the year in which the participant reaches age 70, the applicable distribution period for the participant is the distribution period for age 70 under the Uniform Lifetime Table set forth in section 1.401(a)(9)–9 of the Treasury regulations plus the excess of 70 over the age of the participant as of the participant's birthday in the year that contains the annuity starting date. If the participant's spouse is the participant's sole designated beneficiary and the form of distribution is a period certain and no life annuity, the period certain may not exceed the longer of the participant's applicable distribution period, as determined under this section 4.2, or the joint life and last survivor expectancy of the participant and the participant's spouse as determined under the Joint and Last Survivor Table set forth in section 1.401(a)(9)–9 of the Treasury regulations, using the participant's and spouse's attained ages as of the participant's and spouse's birthdays in the calendar year that contains the annuity starting date.

Section 5. Requirements For Minimum Distributions Where Participant Dies Before Date Distributions Begin.

5.1. Participant Survived by Designated Beneficiary. Except as provided in the adoption agreement, if the participant dies before the date distribution of his or her interest begins and there is a designated beneficiary, the participant's entire interest will be distributed, beginning no later than the time described in section 2.2(a) or (b), over the life of the designated beneficiary or over a period certain not exceeding:

(a) unless the annuity starting date is before the first distribution calendar year, the life expectancy of the designated beneficiary determined using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the calendar year of the participant's death; or

(b) if the annuity starting date is before the first distribution calendar year, the life expectancy of the designated beneficiary determined using the beneficiary's age as of the beneficiary's birthday in the calendar year that contains the annuity starting date.

5.2. No Designated Beneficiary. If the participant dies before the date distributions begin and there is no designated beneficiary as of September 30 of the year following the year of the participant's death, distribution of the participant's entire interest will be completed by December 31 of the calendar year containing the fifth anniversary of the participant's death.

5.3. Death of Surviving Spouse Before Distributions to Surviving Spouse Begin. If the participant dies before the date distribution of his or her interest begins, the participant's surviving spouse is the participant's sole designated beneficiary, and the surviving spouse dies before distributions to the surviving spouse begin, this section 5 will apply as if the surviving spouse were the participant, except that the time by which distributions must begin will be determined without regard to section 2.2(a).

Section 6. Definitions.

6.1. Designated beneficiary. The individual who is designated as the beneficiary under section _______ of the plan and is the designated beneficiary under section 401(a)(9) of the Internal Revenue Code and section 1.401(a)(9)–1, Q&A-4, of the Treasury regulations.

6.2. Distribution calendar year. A calendar year for which a minimum distribution is required. For distributions beginning before the participant's death, the first distribution calendar year is the calendar year immediately preceding the calendar year which contains the participant's required beginning date. For distributions beginning after the participant's death, the first distribution calendar year is the calendar year in which distributions are required to begin pursuant to section 2.2.

6.3 Life expectancy. Life expectancy as computed by use of the Single Life Table in section 1.401(a)(9)–9 of the Treasury regulations.

6.4. Required beginning date. The date specified in section _______ of the plan.

Adoption Agreement

(Check and complete section 1 below if any required minimum distributions for the 2002 distribution calendar year were made in accordance with the § 401(a)(9) Final and Temporary Regulations.)

Section 1. Effective Date of Plan Amendment for Section 401(a)(9) Final and Temporary Treasury Regulations.

_______ Article _______, Minimum Distribution Requirements, applies for purposes of determining required minimum distributions for distribution calendar years beginning with the 2003 calendar year, as well as required minimum distributions for the 2002 distribution calendar year that are made on or after .

(Check and complete any of the remaining sections if you wish to modify the rules in sections 2.2 and 5 of Article _______ of the plan.)

Section 2. Election to Apply 5-Year Rule to Distributions to Designated Beneficiaries.

_______ If the participant dies before distributions begin and there is a designated beneficiary, distribution to the designated beneficiary is not required to begin by the date specified in section 2.2 of Article _______ of the plan, but the participant's entire interest will be distributed to the designated beneficiary by December 31 of the calendar year containing the fifth anniversary of the participant's death. If the participant's surviving spouse is the participant's sole designated beneficiary and the surviving spouse dies after the participant but before distributions to either the participant or the surviving spouse begin, this election will apply as if the surviving spouse were the participant.

This election will apply to:

_______All distributions.
_______The following distributions:

_________________________.

Section 3. Election to Allow Participants or Beneficiaries to Elect 5-Year Rule.

_______ Participants or beneficiaries may elect on an individual basis whether the 5-year rule or the life expectancy rule in sections 2.2 and 5 of Article _______ of the plan applies to distributions after the death of a participant who has a designated beneficiary. The election must be made no later than the earlier of September 30 of the calendar year in which distribution would be required to begin under section 2.2 of Article of the plan, or by September 30 of the calendar year which contains the fifth anniversary of the participant's (or, if applicable, surviving spouse's) death. If neither the participant nor beneficiary makes an election under this paragraph, distributions will be made in accordance with sections 2.2 and 5 of Article_______ of the plan and, if applicable, the elections in section 2 above.

Section 4. Election to Allow Designated Beneficiary Receiving Distributions Under 5-Year Rule to Elect Life Expectancy Distributions.

_______ A designated beneficiary who is receiving payments under the 5-year rule may make a new election to receive payments under the life expectancy rule until December 31, 2003, provided that all amounts that would have been required to be distributed under the life expectancy rule for all distribution calendar years before 2004 are distributed by the earlier of December 31, 2003, or the end of the 5-year period.

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26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

Rev. Proc. 2002–30

SECTION 1. PURPOSE

This revenue procedure provides for a pilot program that will test whether the process for issuing Technical Advice Memoranda (TAMs) can be streamlined. The new advice will be known as a Technical Expedited Advice Memorandum (TEAM). During the TEAM pilot program, only issues under the jurisdiction of the Associate Chief Counsel (Income Tax & Accounting) will be eligible for a TEAM.

The purpose of the new TEAM pilot program is to expedite certain aspects of the TAM process and to eliminate certain requirements (taxpayer and field agreement on facts) that may delay or frustrate the process. Accordingly, the Office of Chief Counsel will provide an answer even if the taxpayer and.the field disagree on the facts. The Office of Chief Counsel, in appropriate circumstances, may issue two separate answers: one based on the field's factual submission and the other based on the taxpayer's.

If the TEAM pilot program is successful, the Office of Chief Counsel expects to expand it to cover other types of issues and all Associate offices. The program also may be made permanent in Rev. Proc. 2003–2 or a subsequent annual revenue procedure. To that end, comments from taxpayers and practitioners regarding the TEAM pilot program are solicited and may be mailed to:

Internal Revenue Service
CC:ITA:RU (RP–124153–02)
Room 5226
POB 7604
Ben Franklin Station
Washington, DC 20044
Attn: A. Lawan Jackson

Submissions may also be delivered Monday through Friday between the hours of 8 a.m. and 5 p.m to CC:ITA:RU (RP–124153–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically by submitting comments directly to the following IRS e-mail address: *Notice.Comments@irscounsel.treas.gov.*

SECTION 2. EFFECT OF A TEAM

A TEAM issued under this revenue procedure will have the same force and legal effect as a TAM requested under Rev. Proc. 2002–2, 2002–1 I.R.B. 82, except as described in sections 8, 10, and 11 of this revenue procedure. Therefore, the field must process the taxpayer's case on the basis of the conclusions in the TEAM, subject to the conditions and limitations described in Rev. Proc. 2002–2, and sections 8, 10, and 11 of this revenue procedure.

SECTION 3. DEFINITIONS

For purposes of this revenue procedure—

(1) The term "taxpayer" includes all persons subject to any provision of the Internal Revenue Code (including issuers of section 103 obligations) and, when appropriate, their representatives;

(2) The term "Associate" means the Associate Chief Counsel (Income Tax & Accounting);

(3) The term "field" refers to field counsel and exam and appeals personnel;

(4) The term "field counsel" refers to any attorney with the Office of Chief Counsel who is not part of the national office or Division Counsel Headquarters;

(5) The term "director" refers to the Director, Field Operations, LMSB; the Territory Manager, Field Compliance, SB/SE; or the Director, Compliance, W&I, as appropriate, and their respective offices; and

(6) The term "area director, appeals" refers to the Area Director, Appeals LBSP, or the Area Director, General Appeals Programs, as appropriate.

SECTION 4. SCOPE

The TEAM pilot program is limited to TAM requests originating during the examination or appeals process that are submitted to the Associate Chief Counsel (Income Tax & Accounting). All TAM requests with issues under the jurisdiction of the Associate will be eligible for the TEAM procedures, except for requests that require coordination outside of the Associate's office. If the request requires coordination outside of the Associate's office, the TAM procedures set forth in Rev. Proc. 2002–2 will apply. During the pendency of the TEAM pilot program, all TAM requests to the Associate (whether or not eligible for the pilot program) must be submitted through the presubmission procedures set forth in section 6 of this revenue procedure. TEAM treatment will be available only after the taxpayer, the field and the Associate agree that such treatment is appropriate following the presubmisson conference described in section 6.

SECTION 5. WHO IS RESPONSIBLE FOR REQUESTING A TEAM?

Requests for a TEAM. A request for a TEAM can originate with the taxpayer, exam or appeals personnel, or field counsel. All requests for a TEAM must be submitted through the supervisory chain for exam or appeals and must be approved by the director or equivalent official in the respective operating divisions or by the area director, appeals (or by an official authorized to act on their behalf) before submission to the Associate. If the director or equivalent official declines to approve the request, then the denial can be appealed to the Division Commissioner for that Operating Division or to the Deputy Director, General Appeals Programs or Director, Appeals, LBSP.

Taxpayer initiated request. While a case is under the jurisdiction of a director or area director, appeals, a taxpayer may make a written or oral request to the examining agent or appeals officer that an issue be referred to the Associate for a TEAM.

Field counsel initiated request. Exam or appeals personnel can request advice from field counsel on issues involved in cases under their jurisdiction. If, during the discussion of an issue with an examining agent or appeals officer, field counsel believes an issue warrants consideration as a TEAM, then field counsel may make a written or oral request to the examining agent or appeals officer that the issue be referred to the Associate for a TEAM.

Resolution of conflicts over requests for a TEAM. If, after considering a request by the taxpayer or field counsel that an issue be submitted for a TEAM, the examining agent or appeals officer disagrees with the request, the taxpayer or the field counsel may raise the request through the examining agent's or the appeals officer's supervisory chain.

SECTION 6. HOW ARE PRESUBMISSION CONFERENCES SCHEDULED?

Field counsel will work closely with the examining agents or appeals officers and the taxpayer in developing the case for a TEAM and in preparing for the presubmission conference. The request for a presubmission conference must be made by FAX to the Associate's office at **202–622–6316**, and must be confirmed in writing by the director or area director, appeals. The receipt of the FAX will be confirmed by the Associate office within one business day. Because the presubmission conference shall involve the taxpayer, as set forth in Rev. Proc. 2002–2, coordination of the request with the taxpayer must begin as soon as reasonably possible after the oral request. Additionally, the field personnel and the taxpayer should agree on what materials to forward to the Associate's office to assist in deciding whether TEAM procedures are appropriate.

Within 5 calendar days of receiving the request, the assigned branch within the Associate's office will contact the field office to schedule the conference. The conference will be held within 15 calendar days of the assigned branch's call to the field office and will be held by telephone, unless the parties specifically request a meeting in person. In no event will a request for an in-person presubmission conference be allowed to delay the conference beyond the 15-day period. The presubmission materials must be received by the assigned branch in the Associate's office no later than 5 calendar days prior to the conference. In order to obtain the protection of taxpayer information offered by the Chief Counsel Intranet "firewall," the presubmission materials shall be electronically transmitted by field counsel to the **CRU-TEAM** e-mail address. To the extent that supporting materials cannot reasonably be submitted, such materials should be sent by FAX, express mail, or private delivery service to avoid any delays in regular mail to the Associate's office.

During the presubmission conference, the parties should determine whether the issue is appropriate for a TEAM, and how the issue should be framed. The participants from the Associate's office will explain the TEAM procedures and the expedited time frames involved. If all parties agree that the TEAM process is desirable, then the request will be processed subject to the TEAM pilot procedures. The parties also should agree on the background documents necessary for the TEAM, and when and how the parties will submit those documents to the Associate.

If the parties do not agree that the TEAM process is appropriate for the issue, the standard TAM procedures of Rev. Proc. 2002–2 may be used.

SECTION 7. WHAT MUST BE INCLUDED IN THE REQUEST FOR A TEAM?

In general, the same procedures should be used for preparing a TEAM request that are used for preparing a TAM request, with the following modifications to Rev. Proc. 2002–2 to expedite the process and to articulate procedures for the TEAM pilot program:

Factual statements. The field, with the assistance of field counsel, will prepare a factual statement. The taxpayer will have 10 calendar days to respond to the field office's facts. If the taxpayer and the field disagree, the parties will have 10 calendar days to attempt to resolve the disagreements. Within 5 calendar days of the expiration of the 10-day period or the day that factual agreement is reached, whichever is earliest, the TEAM request will be forwarded to the Associate. If there is no agreement on the facts, both sets of facts will be forwarded to the Associate. The field, with the assistance of field counsel, will prepare a memorandum highlighting the material factual differences, which memorandum will be provided to the taxpayer.

Submission of documents. All documents will be electronically transmitted by field counsel (followed by hard copy upon the request of the Associate) to the **CRU:TEAM** e-mail address. Additional or supporting documents will be sent by FAX, express mail or private delivery service. The field and the taxpayer are encouraged to provide electronic versions of a proposed TEAM containing the taxpayer's deletions and legends for the Associate's use.

SECTION 8. HOW ARE REQUESTS HANDLED?

If, at the outset, the reviewing branch chief in the Associate's office determines that general guidance should be published regarding the issue presented, the branch chief will immediately notify the Associate. The reviewing branch chief will attempt to make this determination and recommendation as soon as possible, which may occur during the presubmission conference. The criteria for this determination should include whether the issue has a broad application to similarly situated taxpayers or an industry, or resolution of the issue is important to a clear understanding of the tax laws. If the Associate, in consultation with Division Counsel and the Operating Division, agrees that general guidance is desirable, an expedited guidance project will be initiated. The Associate, in consultation with Division Counsel and the Operating Division, also will determine the appropriate resolution of the TEAM request, *i.e.*, whether it may be issued in advance of the general guidance project or must await the publication of guidance. In general, except where policy issues and concerns regarding proper administration of the tax laws require otherwise, the TEAM will be issued in advance of the published guidance.

Within 5 calendar days of the receipt of the TEAM request, the assigned attorney in the Associate's office will contact the field office and the field counsel to confirm the receipt of the request for advice. The assigned Associate attorney and reviewer should also evaluate the issue(s) presented in the TEAM request. If, notwithstanding the presubmission discussion, the Associate concludes that the issue is too complex or otherwise impractical to resolve in the time frames provided below, the Associate may submit a memorandum to the Chief Counsel requesting that the case be excluded from the TEAM process and be treated as a TAM under Rev. Proc. 2002–2. The Associate must discuss this request with both the field and the taxpayer and reflect their views in the memorandum to the Chief Counsel.

Within 20 calendar days of receipt of the TEAM request, the assigned branch in the Associate's office will analyze the facts and offer the taxpayer and the field a conference of right, which will be scheduled for a date within 10 calendar days of the date of the offer for the conference. The conference will be conducted by telephone, unless the taxpayer or the field requests that the conference be held in-person. In no event will the conference be delayed to provide an in person conference rather than a telephone conference.

Following the conference, the taxpayer and the field will have 15 calendar days to provide any supplemental materials. No further conferences will be held. The TEAM will be issued no later than 15 calendar days after the expiration of the 15-day period for supplemental materials.

If two sets of facts are provided to the Associate (*i.e.*, the parties were unable to reach agreement on the facts), the following procedure will be used: If the Associate would rule the same way on either set of facts, a TEAM will be issued, which will note that the factual disagreement is immaterial. If the Associate would rule differently based on which specific set of facts is considered, then a TEAM will be issued describing the resolution of the issue based on each set of facts.

If the TEAM provides alternate responses based on separate sets of facts, the field will not be required to process the case on the basis of the conclusions in the TEAM, as required by section 17.01 of Rev. Proc. 2002–2 in the case of a TAM.

SECTION 9. ISSUANCE OF A TEAM

The Associate will attempt to issue all TEAMs to the field within 60 calendar days of receipt. The Associate will provide the field with the TEAM at the earliest possible date (whether the proposed TEAM is favorable or adverse, in whole or in part, to the taxpayer). The Associate will not provide the taxpayer with the TEAM or advise the taxpayer of a proposed or final conclusion until the Associate has considered a request for reconsideration under section 10 of this revenue procedure or, if no reconsideration is requested, after the expiration of the 30-day period to request reconsideration, whichever occurs later.

SECTION 10. RECONSIDERATION OF A TEAM

The field will have 30 calendar days from issuance to request reconsideration or the TEAM becomes final and will be released to the taxpayer, as is provided in section 17 of Rev. Proc. 2002–2. The request for reconsideration from the field must come from the director or area director, appeals. The request for reconsideration must describe with specificity the errors in the TEAM analysis and conclusions. Requests for reconsideration should not reargue points raised in the initial request, but should instead focus on points that the TEAM overlooked or misconstrued in the field's arguments in support of their request.

The Associate will consider the field's request for reconsideration and rule on that request within 30 calendar days of receipt. The Associate may request further submissions from the field or the taxpayer, but no additional submissions shall be made in the absence of such a request. If the field does not request reconsideration, the TEAM will take effect at the end

of the 30-day period following the issuance of the TEAM to the field. If reconsideration is requested, the TEAM will take effect 5 calendar days after the reconsideration is ruled on.

In the event of a TEAM adverse to the taxpayer, in whole or in part, the taxpayer may request section 7805(b) relief. Such a request will be treated as a separate request subject to the user fee requirements in Rev. Proc. 2002–1. (Similar to section 301.9100 relief.)

SECTION 11. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2002–2, 2002–1 I.R.B. 82, is modified by the supplemental procedures in this revenue procedure. If the TEAM provides alternate responses based on separate sets of facts, the field will not be required to process the case on the basis of the conclusions in the TEAM, as required by section 17.01 of Rev. Proc. 2002–2 in the case of a TAM.

SECTION 12. EFFECTIVE DATE

This revenue procedure is effective on the date of publication in the Internal Revenue Bulletin, and the TEAM pilot procedures will remain in effect until the issuance of Rev. Proc. 2003–2.

SECTION 13. DRAFTING INFORMATION

The principal author of this revenue procedure is Susan L. Hartford of the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this revenue procedure, contact Ms. Hartford at 202–622–4940 (not a toll-free call).

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26 CFR 601.201: Rulings and determination letters. (Also, Part I, §§ 401; 1.401(b)–1.)

Rev. Proc. 2002–35

SECTION 1. PURPOSE

This revenue procedure establishes streamlined procedures to avoid the disqualification of plans intended to satisfy § 401(a) or § 403(a) of the Internal Revenue Code on account of failure to be timely amended for GUST.[1] These streamlined procedures are available only if the plan sponsor applies for a determination letter by September 3, 2002.

SECTION 2. BACKGROUND

.01 Plans intended to satisfy § 401(a) or § 403(a) ("Qualified Plans") are required to be amended for GUST within the GUST remedial amendment period. A plan's GUST remedial amendment period generally ends on the later of February 28, 2002, or the last day of the first plan year beginning on or after January 1, 2001. See Rev. Proc. 2001–55, 2001–49 I.R.B. 552. Special rules apply to governmental plans, plans directly affected by the terrorist attack of September 11, 2001, and plans that are eligible for the extended GUST remedial amendment period that applies to master and prototype and volume submitter plans under section 19 of Rev. Proc. 2000–20, 2000–1 C.B. 553, as modified by Rev. Proc. 2000–27, 2000–1 C.B. 1272, Notice 2001–42, 2001–30 I.R.B. 70, and Rev. Proc. 2001–55.

.02 Rev. Proc. 2001–17, 2001–1 C.B. 589, describes the Employee Plans Compliance Resolution System ("EPCRS"), a comprehensive system of correction programs that, with respect to Qualified Plans, permits plan sponsors to correct qualification failures and thereby preserve the plans' tax-favored status.

SECTION 3. STREAMLINED PROCEDURES

.01 The streamlined procedures in this section apply to Eligible Qualified Plans. The term "Eligible Qualified Plan" means a Qualified Plan that has not been amended for GUST within its GUST remedial amendment period and for which an application for a determination letter that considers all of the requirements of GUST is filed by September 3, 2002. However, a plan is not an Eligible Qualified Plan if the plan is a late amender without regard to GUST (for example, in the case of a plan other than a governmental or nonelecting church plan, if the plan was not timely amended for the Tax Reform Act of 1986, the Unemployment Compensation Act of 1992 or the Omnibus Budget and Reconciliation Act of 1993.) For purposes of this revenue procedure, the failure to amend any disqualifying provision for which the GUST remedial amendment period is available will be treated as a failure to amend the plan for GUST.

.02 The procedures in this section apply to Eligible Qualified Plans in lieu of the procedures in Rev. Proc. 2001–17. Rev. Proc. 2001–17 will continue to apply to late amended plans that are not eligible under this revenue procedure, including late amended plans for which determination letter applications are not filed by September 3, 2002.

.03 The Service will, upon resolution of the determination letter application, treat an Eligible Qualified Plan as having been amended for GUST within the GUST remedial amendment period and issue a favorable determination letter if the plan sponsor has submitted payment of the fee described in section 3.04. This fee is in addition to the determination letter user fee, if applicable.

[1] "GUST" refers to the following:

- the Uruguay Round Agreements Act, Pub. L. 103–465;
- the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103–353;
- the Small Business Job Protection Act of 1996, Pub. L. 104–188;
- the Taxpayer Relief Act of 1997, Pub L. 105–34;
- the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105–206; and
- the Community Renewal Tax Relief Act of 2000, Pub. L. 106–554.

.04 The amount of the fee is as follows:

Number of Participants (per Form 5300 or Form 5307)	Fee
1 – 100	$1,000
101 – 1000	$3,000
1001 or more	$10,000

.05 If the plan sponsor of a late amended Qualified Plan does not resolve the failure to timely amend the plan under this revenue procedure or under Rev. Proc. 2001–17, the plan will be subject to disqualification.

SECTION 4. APPLICATION PROCEDURES

.01 A plan sponsor of an Eligible Qualified Plan may apply to have the failure to timely amend the plan resolved under this revenue procedure by filing a complete GUST determination letter application by September 3, 2002. If the application is filed on or after July 17, 2002, the application should include a check or money order, made payable to the U.S. Treasury, in the amount of the fee determined under section 3.04. This fee and the appropriate determination letter user fee, if applicable, should be paid using separate checks or money orders, each appropriately annotated. The phrase "Rev. Proc. 2002–35" should be written in bold at the top of the Form 5300 or Form 5307. The application should be sent to the appropriate address in section 6.18 of Rev. Proc. 2002–6, 2002–1 I.R.B. 203.

.02 If the Service determines that a plan for which a GUST determination letter application has been filed by September 3, 2002, is a GUST late amender, and the plan sponsor has not submitted payment of the fee under section 3.04, the Service will contact the plan sponsor to offer the sponsor the opportunity to request consideration under this procedure, or, if the plan is not an Eligible Qualified Plan, under Rev. Proc. 2001–17. Therefore, plan sponsors of late amended plans that have filed GUST determination letter applications before July 17, 2002, need take no further action until contacted by the Service.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2001–17 is modified.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective on June 17, 2002.

DRAFTING INFORMATION

The principal author of this revenue procedure is James Flannery of Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue procedure, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday (a toll-free number). Mr. Flannery may be reached at 1–202–283–9888 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, §§ 30, 50, 179, 179A.)

Rev. Proc. 2002–42

SECTION 1. PURPOSE

This revenue procedure sets forth a process that allows taxpayers who purchase certain clean-fuel vehicle property to rely on a manufacturer's certification of the incremental cost of the property for purposes of the clean-fuel vehicle property deduction provided in § 179A of the Internal Revenue Code. This revenue procedure applies to motor vehicles (other than buses, and trucks and vans with a gross vehicle weight rating greater than 10,000 pounds) that are propelled by both a gasoline internal combustion engine and an electric motor that is recharged as the motor vehicles operate (hybrid vehicles) and that otherwise meet the requirements of § 179A.

SECTION 2. BACKGROUND

.01 *In general.* Section 179A allows a deduction for certain costs of "qualified clean-fuel vehicle property" for the tax year in which the property is placed in service. In the case of hybrid vehicles, only the incremental cost of permitting the use of the clean-burning fuel (electricity) can be taken into account when determining the allowable deduction under § 179A.

The Internal Revenue Service has received numerous inquiries from taxpayers concerning the determination of the incremental cost for specific hybrid vehicles for purposes of § 179A. This revenue procedure sets forth a process allowing a taxpayer who purchases a hybrid vehicle to rely on the original equipment manufacturer's (or, in the case of a foreign original equipment manufacturer, its domestic distributor's) certification of the incremental cost of the property for purposes of § 179A.

.02 *Qualifying Motor Vehicles.* This revenue procedure applies only to motor vehicles that meet the requirements of § 179A. In order to be eligible for the deduction under § 179A, a motor vehicle must: (1) be acquired for use by the taxpayer and not for resale and have its original use commence with the taxpayer; (2) meet the applicable federal and state emissions standards with respect to each fuel by which the vehicle is propelled; (3) be manufactured primarily for use on public streets, roads, and highways; (4) have at least four wheels; and (5) not operate exclusively on a rail or rails. Section 179A and this revenue procedure do not apply to motor vehicles that are primarily powered by electricity and qualify for the credit provided in § 30 or to motor vehicles that are used predominantly outside the United States.

.03 *Deduction Amount Limitations.* Under § 179A, except in the case of any truck or van with a gross vehicle weight rating greater than 10,000 pounds or any bus with a seating capacity of at least 20 adults (not including the driver), the maximum cost that may be taken into account when determining the deduction is $2,000 for motor vehicles placed in service on or before December 31, 2003. The $2,000 maximum is reduced by 25 percent for motor vehicles placed in service in calendar year 2004, 50 percent for motor vehicles placed in service in calendar year 2005, and 75 percent for motor vehicles placed in service in calendar year 2006. No deduction is allowed for motor vehicles placed in service after December 31, 2006. No deduction is allowed with

respect to the portion of the cost of any property taken into account under § 179.

SECTION 3. PROCEDURE

.01 *Original Equipment Manufacturer's Certification*. An original equipment manufacturer (or in the case of a foreign original equipment manufacturer, its domestic distributor) may prepare a certification concerning the incremental cost of permitting the use of electricity to propel its vehicles. The certification should contain the following information:

(1) the name and address of the certifying entity;

(2) the make, model, year, and any other appropriate identifiers of the motor vehicle; and

(3) a statement disclosing the total per-vehicle cost to acquire and install the motor vehicle's electric motor and related generating, storage, and delivery equipment. If the total cost exceeds $2,000, the statement may so indicate without disclosing the specific amount of the cost.

The certification should be signed by an officer of the original equipment manufacturer (or, in the case of a foreign original equipment manufacturer, an officer of its domestic distributor). This original signed certification must be sent to the Internal Revenue Service, Industry Director, Large and Mid-Size Business, Heavy Manufacturing and Transportation, Metro Park Office Complex — LMSB, 111 Wood Avenue, South, Iselin, New Jersey 08830.

.02 *Internal Revenue Service's Acknowledgment*. The Internal Revenue Service will review the original signed certification and issue an acknowledgment letter to the original equipment manufacturer (or, in the case of a foreign original equipment manufacturer, its domestic distributor). This acknowledgment letter will state whether purchasers may rely on the certification.

.03 *Purchaser's Reliance*. Copies of the certification and acknowledgment may be made available to purchasers. Except as otherwise provided in the acknowledgment, a purchaser of a hybrid vehicle may rely on the certification concerning the incremental cost of permitting the use of electricity to propel the vehicle.

SECTION 4. DRAFTING INFORMATION

The principal author of this revenue procedure is Jolene J. Shiraishi of the Office of the Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue procedure, contact Ms. Shiraishi at (202) 622–3120 (not a toll free call).

Part IV. Items of General Interest

Announcement and Report Concerning Pre-Filing Agreements

Announcement 2002–54

Introduction

This Announcement is issued pursuant to the Conference Report to H.R. 4577 (Pub. L. 106–554), *The Community Renewal Tax Relief Act of 2000*, which requires that the Secretary of the Treasury make publicly available an annual report relating to the Pre-Filing Agreement ("PFA") program operations for the preceding calendar year. The Conference Report states that the report is to include: (1) the number of pre-filing agreements completed, (2) the number of applications received, (3) the number of applications withdrawn, (4) the types of issues which are resolved by completed agreements, (5) whether the program is being utilized by taxpayers who were previously subject to audit, (6) the average length of time required to complete an agreement, (7) the number, if any, and subject of technical advice and Chief Counsel advice memoranda issued to address issues arising in connection with any pre-filing agreement, (8) any model agreements, and (9) any other information the Secretary deems appropriate. This is the second annual report and provides information on the four remaining PFA pilot program cases that closed in calendar year 2001. This report also provides similar information concerning case activity that started with the permanent program (Rev. Proc. 2001–22, 2001–1 C.B. 745).

Background

The Large and Mid-Size Business Division ("LMSB") within the Internal Revenue Service serves corporations and partnerships with assets greater than $10 million. In 2001, approximately 170,000 corporations and partnerships filed returns reporting assets in this range. The returns filed by these taxpayers present a wide variety of complex issues. Taxpayers served by LMSB reported a total tax liability of $350 billion during 2001. The largest of the taxpayers deal with the IRS on a continuous basis.

One of LMSB's strategic initiatives is issue management. Through effective issue management, LMSB seeks to resolve issues of tax controversy on a more current basis. This includes, but is not limited to, increasing the efficiency of the examination process and seeking alternative issue resolution tools. The Pre-Filing Agreement program was designed to support LMSB's issue management strategy. LMSB believes the Pre-Filing Agreement program reduces taxpayer burden and make more effective use of IRS resources by resolving or eliminating tax controversy before the tax return is filed.

Pre-Filing Agreement Program

The PFA program is designed to permit a taxpayer to resolve, before the filing of a return, the treatment of an issue that otherwise would likely be disputed in a post-filing examination. The PFA program is intended to produce agreement on factual issues and apply settled legal principles to those facts. A PFA is a specific matter closing agreement under § 7121 of the Internal Revenue Code and resolves the subject of the PFA for a taxable period. Execution of a PFA that resolves issues prior to filing permits taxpayers to avoid a portion of the costs, burdens and delays that are frequently incident to post-filing examination disputes between taxpayers and the IRS.

In calendar year 2000, the pilot program was implemented which resulted in the execution of seven PFAs. Four cases remained in process at the end of calendar year 2000 and all four cases were closed during calendar year 2001. A PFA was executed in three of the four cases. Based upon input from internal and external participants in the pilot program, the IRS expanded the PFA program and made it permanent.

Pilot Pre-Filing Agreement Program Completion

PFA Pilot Program

The PFA pilot program was open to Coordinated Examination Program ("CEP") taxpayers that had a CEP examination team currently on site (CEP cases have been renamed Coordinated Industry Cases (CIC)). Notice 2000–12, 2000–1 C.B. 727, dated February 11, 2000, provided a description of a PFA, the procedures for requesting a PFA, and the procedures for LMSB to select taxpayers for the PFA pilot program. The IRS believed that this PFA pilot program offered significant benefits for taxpayers, as well as for the IRS, and invited large business taxpayers to participate. Notice 2000–12 requested interested taxpayers to submit applications for the PFA pilot program by March 15, 2000, through the on site LMSB team manager. During the PFA pilot, eleven cases were accepted into the pilot program. Of the eleven, seven were closed during calendar year 2000 and reflected in the first report (Announcement 2001–38, 2001–1 C.B. 1138, dated April 23, 2001). The remaining four cases were closed during calendar year 2001. This report reflects the activity of the four pilot cases closed in calendar year 2001.

The taxpayers and the respective Industry Directors, in accordance with the provisions of Notice 2000–12, agreed to continue discussions relating to the four PFAs that were in process at December 31, 2000.

Industry Segment	Issue	In-Process @12/31/00
Heavy Manufacturing & Transportation	Research Credit	1
Heavy Manufacturing & Transportation	Valuation of Assets	1
Communications, Technology & Media	Research Credit	1
Retailers, Food, Pharmaceuticals & Healthcare	Expense vs. Capitalization	1

During calendar year 2001, the four pilot cases were closed in the following manner:

Status of PFAs	Issue
Executed PFA	Research Credit
Executed PFA	Valuation of Assets
Executed PFA	Research Credit
PFA Withdrawn	Expense vs. Capitalization

Executed PFAs — Research Credit

Two applicants sought PFAs regarding the amount of research credit each could claim as a result of various activities undertaken to improve products. In both instances, IRS specialists and other non-Service outside experts were involved in the process of ascertaining what activities qualified for the credit. In one case, the analysis involved consideration of the activities of over 1,500 different departments. Closing agreements were executed in both cases.

Executed PFA — Valuation of Assets

This case involved a determination of value related to the sale of assets and stock of a subsidiary to an unrelated party. An allocation of the net selling price among the assets and stock sold, the basis of the assets sold, and the taxable gain or loss were at issue. A closing agreement was executed regarding all of these issues.

PFA Withdrawn — Expense vs. Capitalization

The issue in this case related to whether certain repairs and maintenance expenditures were deductible or should be capitalized and depreciated over their useful life. A closing agreement with multi-year application which was sought by the taxpayer could not be provided under the terms of the Delegation Order for the PFA program. Consequently, both the Service and the taxpayer mutually agreed to withdraw from the PFA process.

Closing Agreements

The above three PFAs were executed during 2001. A pro forma or model agreement does not exist for a PFA. A PFA represents a specific matter closing agreement under § 7121. The closing agreements entered into under this program were prepared with assistance from the Office of Chief Counsel and conform to the guidance provided in Rev. Proc. 68–16, 1968–1 C.B. 770.

Processing Statistics

The average elapsed time to resolve the four cases described above that were closed in calendar year 2001 was 482.75 days.

Average Processing Time for Four Cases Closed in 2001	Range (Elapsed Days)	Average (Elapsed Days)
Phase I —Application Screening Process	21–86	44.5
Phase II — PFA Evaluation Process	292–533	438.25
Total Time to Close a PFA Case	322–574	482.75

Phase I — Application Screening Process

The initial phase was the screening process to determine if an application was appropriate for inclusion in the PFA pilot program. This screening process included obtaining comments from various LMSB functions and Chief Counsel, the review of these comments, and the decision making process on the acceptance/rejection of an application by the Industry Director. The average elapsed time from the date an application was received by the IRS until the Industry Director rendered a decision to accept or reject an application was 44.5 days.

Phase II — PFA Evaluation Process

The second (and final) phase in the PFA pilot program process was the evaluation phase. This phase began when the Industry Director accepted an application into the PFA program and ended when a PFA was executed or the case was otherwise closed. The average elapsed time for the four cases was 438.25 days.

Program Evaluation

The PFA Program Manager ensures that an evaluation of all of the PFA program cases, based on feedback from LMSB employees and taxpayer participants, is conducted. As a part of this program evaluation, participants were asked to provide the actual direct examination time expended to complete the PFA and an estimate of the direct examination time it would have taken to resolve the issue in a post-filing context.

Cumulative Hours (Executed PFAs)	Taxpayer (Hours) (2 executed PFAs)	LMSB (Hours) (3 executed PFAs)
Actual — PFA Process	25,920	17,192
Estimated — Post-Filing Process	59,500	31,860
Estimated Savings	33,580	14,668
Estimated Savings Percentage (Average)	56.4%	46%
Estimated Savings Percentage (Range)	(28%) – 59%	(12.4%) – 61%

One taxpayer who executed a PFA did not participate in the program evaluation phase of the PFA process.

Pre-Filing Agreement Pilot Program Summary

After evaluating the PFA pilot program and receiving input from internal and external participants, the IRS concluded that the PFA program supports the LMSB issue management strategy by assisting taxpayers to resolve issues in a cost efficient and cooperative environment. Accordingly, the IRS issued Rev. Proc. 2001–22, which expanded the PFA program and made it permanent.

Permanent Pre-Filing Agreement Program

PFA Program

As a result of the success of the pilot program, the Service established a permanent PFA Program with the issuance of Rev. Proc. 2001–22. Although many of the procedures remained the same, there were some significant changes, including:

1. All taxpayers within the jurisdiction of LMSB are eligible to participate;
2. More issues are considered appropriate;
3. There are fewer excludible circumstances;
4. Certain international issues are now considered appropriate; and
5. A user fee was implemented for those taxpayers accepted into the program.

PFA Process

The PFA process is managed and conducted by LMSB Industry Directors and field staff, with support from the Office of Pre-Filing and Technical Guidance in LMSB Headquarters. The PFA Program Manager receives all applications and, with the assistance of the Technical Advisors and the Office of Chief Counsel, ensures that the issues presented are appropriate for inclusion in the PFA program.

The Industry Director with jurisdiction over the taxpayer makes the final decision whether to accept a taxpayer's request for participation in the PFA program. The criteria for selecting a request include:

a. The suitability of the issue presented by the taxpayer;
b. The direct or indirect impact of a PFA upon other years, issues, taxpayers, or related cases;
c. The availability of Service resources;
d. The ability and willingness of the taxpayer to dedicate sufficient resources to the process;
e. The likelihood that the PFA may result in contrary positions with respect to an item or transaction ("whipsaw"); and
f. The probability of completing the examination of the issue and entering into a PFA by the target date.

For the cases selected, a mandatory orientation session for the examination team and the taxpayer is conducted. Subsequently, the taxpayer and examination team convene a joint planning meeting to reach agreement on a proposed timeframe, to identify and arrange for IRS access to relevant records and testimony, and to define the potential scope and nature of the PFA.

The examination team conducts the factual determination and issue development consistent with IRS auditing standards. Based upon an examination of the issue, the Team Manager prepares a PFA recommendation for the Industry Director. The Industry Director's decision to enter into a PFA is based on the Team Manager's recommendation and discussions with the PFA Program Manager, Chief Counsel attorneys, appropriate Technical Advisors and the taxpayer. Following Chief Counsel review to ensure that the proposed PFA conforms with guidance provided in Rev. Proc. 68–16 (regarding closing agreements), the Industry Director could execute a PFA if he or she determines that:

a. Entering into the PFA is consistent with the goals of the PFA program as stated in Rev. Proc. 2001–22;
b. The resolution in the PFA reflects settled legal principles and correctly applies those principles (or positions authorized under Delegation Order Nos. 236 or 247) to facts found by the Examination Team; and
c. There appears to be an advantage in having the issue(s) permanently and conclusively closed for the taxable period covered by the PFA, or that the taxpayer shows good and sufficient reasons for desiring a closing agreement and that the United States would sustain no disadvantage

through consummation of such an agreement (see § 301.7121–1(a) of the Procedure and Administration Regulations).

Program Oversight

A designated PFA Program Manager and an analyst assigned to the Office of Pre-Filing and Technical Guidance in LMSB Headquarters provide oversight for the PFA program. The PFA Program Manager provides assistance to taxpayers, Industry Directors and Team Managers throughout the process.

Pre-Filing Agreement Program Accomplishments

Applications Received

Twenty-six applications were received for the permanent PFA program in calendar year 2001. Applications were received from each LMSB industry segment and involved a variety of issues.

Number of Requests Received by Industry

Industry Segment	***Received***
Financial Services	10
Retailers, Food, Pharmaceuticals & Healthcare	3
Natural Resources & Construction	4
Communications, Technology & Media	3
Heavy Manufacturing, Construction & Transportation	6
Total	26

Types of Issues Received

Issue	Received
Deductibility of interest	1
Fair Market Value of Assets	3
Expense vs. Capitalization	1
Tax Basis & Holding Period	1
Excise Tax Allocation	2
Reorganization & Stock Basis	1
Research & Experiment Credit	3
Bad Debts & Worthless Securities	1
Gain on Sale	1
Amortization of Intangibles	1
Class Life Determination	2
Deductibility of Indemnification Payments	1
Acquiring parent — method of accounting	1
NOL Determination	1
Demutualization & IPO	2
Foreign Business Cessation	1
Acquisition & Liquidation	1
Cost Basis Determination	1
Complete Liquidation & Bankruptcy	1
Total	26

Applications Not Accepted

Eight applications were not considered appropriate for the PFA program.

Reasons for Non-acceptance	Applications
Issue Not Suitable or Ineligible	4
International Issue Not Listed in Rev. Proc. 2001–22	1
Not Well-Settled Law	1
Change of Accounting Method (Form 3115)	1
Not Under Jurisdiction of LMSB	1
Total	8

Applications Accepted

Eighteen applications from the twenty-six taxpayer submissions were accepted into the permanent PFA program. The status of these applications on December 31, 2001, was as follows:

Status of PFAs @ 12/31/01	Applications
PFA Request Withdrawn by Taxpayer	1
PFA Request Withdrawn by IRS	1
PFAs In-process	11
PFAs Executed	5
Total	18

Taxpayer Withdrawal (1)

One taxpayer, in accordance with the procedures set forth in Section 8 of Rev. Proc. 2001–22, withdrew from the PFA program after its request had been accepted. This withdrawal was necessitated, in the view of the taxpayer, due to adverse economic conditions within the company causing a reduction in staffing required to successfully continue the PFA process.

IRS Withdrawal (1)

The Service withdrew from the PFA process in another instance where all issue and factual development had been completed and, after considerable discussions with the taxpayer, it was determined that a closing agreement could not be reached on the issue of the amount of allowable research credit.

PFAs In Process (11)

The taxpayers and the respective Industry Directors, in accordance with the provisions of Rev. Proc. 2001–22, have agreed to continue the PFA process in an effort to reach a closing agreement concerning the 11 in-process cases.

PFAs Executed (5)

Five PFAs were completed in calendar year 2001 under the permanent program.

The Office of Chief Counsel provided advice to the examination teams and assisted in the drafting and review of the PFA closing agreements. No Technical Advice or Chief Counsel Advice Memoranda were issued for issues addressed in the PFA process. The executed PFAs covered the following issues:

PFAs Executed by Issue

Deductibility of Interest	1
Class Life Determination	1
Expense vs. Capitalization	1
Amortization of Intangibles	1
Deductibility of Indemnification Payments	1
Total	5

Deductibility of Interest (1)

An agreement was reached between a taxpayer and the Service that, on the basis of the facts presented, the taxpayer was not subject to disallowance of its interest deductions under § 265(a)(2) because its investment in tax-exempt securities was less than 2 percent of its average total assets and therefore it satisfied the 2 percent safe harbor under § 3.05 of Rev. Proc. 72–18.

Class Life Determination (1)

Taxpayer requested a determination whether they had properly assigned class lives and recovery periods for assets capitalized and placed into service during the taxable year (the PFA year). Additionally, the taxpayer requested a determination as to whether certain assets placed in service in prior periods were properly classified. A closing agreement was executed concerning the assets placed in service during the PFA year. Separately, the taxpayer submitted a request for a change of accounting method to the Office of Chief Counsel concerning the reclassification of assets placed in service in prior tax periods which was consistent with the determination in the PFA year.

Expense vs. Capitalization (1)

Taxpayer requested consideration whether certain expenditures for repairs made during the PFA year were properly deductible or should be capitalized and depreciated over the appropriate recovery period. A closing agreement was executed establishing which portion of the total expenditures was properly expensed and which portion was properly capitalized and subject to depreciation.

Amortization of Intangibles (1)

During the PFA year, the taxpayer entered into a taxable transaction in which it acquired certain amortizable intangible assets. The taxpayer requested a determination as to the value of the intangibles acquired. A closing agreement was executed as to such value.

Deductibility of Indemnification Payments (1)

A majority shareholder made certain payments in settlement of litigation on his own behalf and on behalf of a corporate taxpayer. The corporate taxpayer agreed to indemnify the shareholder a negotiated amount. The corporate taxpayer requested a determination concerning the deductibility of the indemnification payments made to the shareholder during the PFA year. A closing agreement was executed regarding the amounts of deductible and non-deductible payments.

Closing Agreements

Five PFAs were executed in the permanent PFA program during calendar year 2001. A pro forma or model agreement does not exist for a PFA. A PFA represents a specific matter closing agreement under § 7121. The closing agreements entered into under this program were prepared with assistance from the Office of Chief Counsel and conform to the guidance provided in Rev. Proc. 68–16.

Processing Statistics

The average elapsed time to resolve the seven cases (five executed PFAs and two withdrawals) described above that were closed in calendar year 2001 was 172.7 days.

Average Processing Time for Seven Cases Closed in 2001	Range (Elapsed Days)	Average (Elapsed Days)
Phase I — Application Screening Process	16–65	46.6
Phase II — PFA Evaluation Process	54–188	126.1
Total Time to Close a PFA Case	105–253	172.7

Phase I — Application Screening Process

Twenty-six applications were received for the PFA program during calendar year 2001. The initial phase was the screening process to determine if an application was appropriate for inclusion in the PFA program. This screening process included obtaining comments from various LMSB functions and Chief Counsel, the review of these comments, and the decision making process on the acceptance/rejection of an application by the Industry Director. The average time from the date an application was received by the IRS until the Industry Director rendered a decision to accept or reject an application was 63.96 days for all twenty-six applications received in the calendar year 2001 and 46.6 days for the seven cases closed in that year.

Phase II — PFA Evaluation Process

The second (and final) phase in the PFA program process was the evaluation phase. This phase began when the Industry Director accepted an application into the PFA program and ended when a PFA was executed or the case was otherwise closed. The average elapsed time for the seven cases closed in calendar year 2001 was 126.1 days.

Program Evaluation

The PFA Program Manager ensures that an evaluation of all of the PFA program cases, based on feedback from LMSB employees and taxpayer participants, is conducted. As a part of this program evaluation, participants were asked to provide the direct examination time expended to complete the PFA and an estimate of the direct examination time it would have taken to resolve the issue in a post-filing context.

Cumulative Hours (5 Executed PFAs)	Taxpayer (Hours)	LMSB (Hours)
Actual — PFA Process	4,583	6,252
Estimated — Post-Filing Process	13,708	11,873
Estimated Savings	9,125	5,621
Estimated Savings Percentage (Average)	66.6%	47.3%
Estimated Savings Percentage (Range)	50%–98.4%	(8.9)%–92.5%

Comparative Analysis — Processing Statistics

Illustrated below are the average elapsed time (in days) processing statistics for the seven pilot cases that closed in calendar year 2000, the remaining four pilot cases closed in calendar year 2001, and the seven permanent program cases closed in calendar year 2001. In the pilot program, the average total time to conclude the first seven cases, as indicated below, was 164.8 days. The range was from a low of 91 days to a high of 186 days. The four pilot cases that started in calendar year 2000 and closed in calendar year 2001 were concluded in an average total time of 482.75 days. Those cases had a range of 322 to 574 days. The average total time to conclude the seven permanent program cases that started and closed in calendar year 2001 was 172.7 days. The range was from 105 to 253 days.

With regard to the four pilot cases completed in calendar year 2001, the increased time can be attributed to the degree of complexity of the issue and the time necessary to develop the factual aspects of the issue. Generally, the more complex and examination intensive the issue is, the greater the time necessary to complete the process.

Regarding the Phase I — Application Screening Process, we have noted the slight increase in average processing time. With respect to the Phase II and Total Time, the results meet our expectations and may be a positive consequence of the slightly increased Phase I time. Other than the contributing factors stated above, our analysis thus far has not revealed any systemic issues giving rise to this phenomenon.

Average Processing Time for PFAs (Days)	**Pilot CY 2000** (7 cases)	**Pilot CY 2001** (4 cases)	**Overall Pilot** (11 cases)	**Program CY 2001** (7 cases)
Phase I — Application Screening Process	34.7	44.5	38.3	46.6
Phase II — PFA Evaluation Process	130.1	438.25	242.2	126.1
Total Time to Complete a PFA	164.8	482.75	280.5	172.7

Pre-Filing Agreement Program Summary

The PFA program is now available to all LMSB taxpayers, including taxpayers that are not currently under examination. While the PFA program will continue to be limited to issues that involve settled legal principles, the list of recommended issues has been expanded, and now includes certain international issues. Generally, the operational procedures used during the PFA pilot program were adopted and enhanced in the permanent PFA program.

Overall, the PFA program is meeting the LMSB strategic program objectives as contained in its issue management strategic initiative. Issues of potential controversy are being resolved more efficiently and on a more current basis yielding benefits to taxpayers and the IRS.

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Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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Bulletin No. 2002–25
June 24, 2002

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–33, page 1197.
Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning July 1, 2002, will be 6 percent for overpayments (5 percent in the case of a corporation), 6 percent for underpayments, and 8 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 will be 3.5 percent.

Notice 2002–39, page 1204.
Electricity produced from certain renewable resources; calendar year 2002 inflation adjustment factor and reference prices. This notice announces the calendar year 2002 inflation adjustment factor and reference prices for the renewable electricity production credit under section 45 of the Code.

EMPLOYEE PLANS

Notice 2002–38, page 1204.
Weighted average interest rate update. The weighted average interest rate for June 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

ADMINISTRATIVE

Rev. Proc. 2002–34, page 1205.
Magnetic media; electronic filing; 2002 form specifications. Specifications are set forth for the magnetic or electronic filing of 2002 Forms 1098, 1099, 5498, and W–2G. Rev. Proc. 2001–32 superseded.

Announcement 2002–58, page 1284.
The Service announces that Publication 947, *Practice Before the IRS and Power of Attorney* (revised April 2002), is currently available. It replaces the January 1999 revision.

Finding Lists begin on page ii.

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Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cau against reaching the same conclusions in other cases u the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisi the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart Conventions and Other Related Items, and Subpart B, Le tion and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to subjects are contained in the other Parts and Subparts. included in this part are Bank Secrecy Act Administrativ ings. Bank Secrecy Act Administrative Rulings are issu the Department of the Treasury's Office of the Assistant S tary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, d ment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative ind the matters published during the preceding months. T monthly indexes are cumulated on a semiannual basis, an published in the first Bulletin of the succeeding semia period, respectively.

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Section 6621.—Determination of Interest Rate

26 CFR 301.6621–1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning July 1, 2002, will be 6 percent for overpayments (5 percent in the case of a corporation), 6 percent for underpayments, and 8 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 will be 3.5 percent.

Rev. Rul. 2002–33

Section 6621 of the Internal Revenue Code establishes the rates for interest on tax overpayments and tax underpayments. Under § 6621(a)(1), the overpayment rate beginning July 1, 2002, is the sum of the federal short-term rate plus 3 percentage points (2 percentage points in the case of a corporation), except the rate for the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under § 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See § 6621(c) and § 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and § 301.6621–3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under § 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88–59, 1988–1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under § 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with § 6621 which, pursuant to § 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of April 2002 is 3 percent. Accordingly, an overpayment rate of 6 percent (5 percent in the case of a corporation) and an underpayment rate of 6 percent are established for the calendar quarter beginning July 1, 2002. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 for the calendar quarter beginning July 1, 2002, is 3.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning July 1, 2002, is 8 percent. These rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 3.5 percent, 5 percent, 6 percent, and 8 percent are published in Tables 12, 15, 17, and 21 of Rev. Proc. 95–17, 1995–1 C.B. 556, 566, 569, 571, and 575.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Raymond Bailey of the Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions & Judicial Practice Division. For further information regarding this revenue ruling, contact Mr. Bailey at (202) 622–6226 (not a toll-free call).

TABLE OF INTEREST RATES
PERIODS BEFORE JUL. 1, 1975 - PERIODS ENDING DEC. 31, 1986
OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	In 1995–1 C.B. DAILY RATE TABLE
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560

TABLE OF INTEREST RATES
PERIODS BEFORE JUL. 1, 1975 - PERIODS ENDING DEC. 31, 1986
OVERPAYMENTS AND UNDERPAYMENTS—CONTINUED

PERIOD	RATE	In 1995–1 C.B. DAILY RATE TABLE
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25 pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 - DEC. 31, 1998

	OVERPAYMENTS			UNDERPAYMENTS		
		1995–1 C.B.			1995–1 C.B.	
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 - DEC. 31, 1998—CONTINUED

	OVERPAYMENTS			UNDERPAYMENTS		
	1995–1 C.B.			1995–1 C.B.		
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577
Apr. 1, 1997—Jun. 30, 1997	8%	21	575	9%	23	577
Jul. 1, 1997—Sep. 30, 1997	8%	21	575	9%	23	577
Oct. 1, 1997—Dec. 31, 1997	8%	21	575	9%	23	577
Jan. 1, 1998—Mar. 31, 1998	8%	21	575	9%	23	577
Apr. 1, 1998—Jun. 30, 1998	7%	19	573	8%	21	575
Jul. 1, 1998—Sep. 30, 1998	7%	19	573	8%	21	575
Oct. 1, 1998—Dec. 31, 1998	7%	19	573	8%	21	575

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 - PRESENT
NONCORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	1995–1 C.B.		
	RATE	TABLE	PAGE
Jan. 1, 1999—Mar. 31, 1999	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	9%	71	625

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 - PRESENT
NONCORPORATE OVERPAYMENTS AND UNDERPAYMENTS—CONTINUED

	RATE	1995–1 C.B. TABLE	PAGE
Jan. 1, 2001—Mar. 31, 2001	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	6%	17	571

TABLE OF INTEREST RATES
FROM JANUARY 1, 1999 - PRESENT
CORPORATE OVERPAYMENTS AND UNDERPAYMENTS

	OVERPAYMENTS			UNDERPAYMENTS		
		1995–1 C.B.			1995–1 C.B.	
	RATE	TABLE	PG	RATE	TABLE	PG
Jan. 1, 1999—Mar. 31, 1999	6%	17	571	7%	19	573
Apr. 1, 1999—Jun. 30, 1999	7%	19	573	8%	21	575
Jul. 1, 1999—Sep. 30, 1999	7%	19	573	8%	21	575
Oct. 1, 1999—Dec. 31, 1999	7%	19	573	8%	21	575
Jan. 1, 2000—Mar. 31, 2000	7%	67	621	8%	69	623
Apr. 1, 2000—Jun. 30, 2000	8%	69	623	9%	71	625
Jul. 1, 2000—Sep. 30, 2000	8%	69	623	9%	71	625
Oct. 1, 2000—Dec. 31, 2000	8%	69	623	9%	71	625
Jan. 1, 2001—Mar. 31, 2001	8%	21	575	9%	23	577
Apr. 1, 2001—Jun. 30, 2001	7%	19	573	8%	21	575
Jul. 1, 2001—Sep. 30, 2001	6%	17	571	7%	19	573
Oct. 1, 2001—Dec. 31, 2001	6%	17	571	7%	19	573
Jan. 1, 2002—Mar. 31, 2002	5%	15	569	6%	17	571
Apr. 1, 2002—Jun. 30, 2002	5%	15	569	6%	17	571
Jul. 1, 2002—Sep. 30, 2002	5%	15	569	6%	17	571

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 - PRESENT

	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 - PRESENT—CONTINUED

	RATE	1995–1 C.B. TABLE	PG
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581
Jan. 1, 1998—Mar. 31, 1998	11%	27	581
Apr. 1, 1998—Jun. 30, 1998	10%	25	579
Jul. 1, 1998—Sep. 30, 1998	10%	25	579
Oct. 1, 1998—Dec. 31, 1998	10%	25	579
Jan. 1, 1999—Mar. 31, 1999	9%	23	577
Apr. 1, 1999—Jun. 30, 1999	10%	25	579
Jul. 1, 1999—Sep. 30, 1999	10%	25	579
Oct. 1, 1999—Dec. 31, 1999	10%	25	579
Jan. 1, 2000—Mar. 31, 2000	10%	73	627
Apr. 1, 2000—Jun. 30, 2000	11%	75	629
Jul. 1, 2000—Sep. 30, 2000	11%	75	629
Oct. 1, 2000—Dec. 31, 2000	11%	75	629
Jan. 1, 2001—Mar. 31, 2001	11%	27	581
Apr. 1, 2001—Jun. 30, 2001	10%	25	579

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 - PRESENT—CONTINUED

	RATE	1995–1 C.B. TABLE	PG
Jul. 1, 2001—Sep. 30, 2001	9%	23	577
Oct. 1, 2001—Dec. 31, 2001	9%	23	577
Jan. 1, 2002—Mar. 31, 2002	8%	21	575
Apr. 1, 2002—Jun. 30, 2002	8%	21	575
Jul. 1, 2002—Sep. 30, 2002	8%	21	575

TABLE OF INTEREST RATES FOR
CORPORATE OVERPAYMENTS EXCEEDING $10,000
FROM JANUARY 1, 1995 - PRESENT

	RATE	1995–1 C.B. TABLE	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572
Jan. 1, 1998—Mar. 31, 1998	6.5%	18	572
Apr. 1, 1998—Jun. 30, 1998	5.5%	16	570
Jul. 1, 1998—Sep. 30, 1998	5.5%	16	570
Oct. 1, 1998—Dec. 31, 1998	5.5%	16	570
Jan. 1, 1999—Mar. 31, 1999	4.5%	14	568
Apr. 1, 1999—Jun. 30, 1999	5.5%	16	570
Jul. 1, 1999—Sep. 30, 1999	5.5%	16	570
Oct. 1, 1999—Dec. 31, 1999	5.5%	16	570
Jan. 1, 2000—Mar. 31, 2000	5.5%	64	618
Apr. 1, 2000—Jun. 30, 2000	6.5%	66	620
Jul. 1, 2000—Sep. 30, 2000	6.5%	66	620
Oct. 1, 2000—Dec. 31, 2000	6.5%	66	620
Jan. 1, 2001—Mar. 31, 2001	6.5%	18	572
Apr. 1, 2001—Jun. 30, 2001	5.5%	16	570
Jul. 1, 2001—Sep. 30, 2001	4.5%	14	568
Oct. 1, 2001—Dec. 31, 2001	4.5%	14	568

TABLE OF INTEREST RATES FOR
CORPORATE OVERPAYMENTS EXCEEDING $10,000
FROM JANUARY 1, 1995 - PRESENT—CONTINUED

		1995–1 C.B.	
	RATE	TABLE	PG
Jan. 1, 2002—Mar. 31, 2002	3.5%	12	566
Apr. 1, 2002—Jun. 30, 2002	3.5%	12	566
Jul. 1, 2002—Sep. 30, 2002	3.5%	12	566

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2002–38

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73, 1988–2 C.B. 383, provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for May 2002 is 5.65 percent. Pursuant to Notice 2002–26, 2002–15 I.R.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
June	2002	5.68	5.11 to 6.24	5.11 to 6.81

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1–202–283–9888 (not a toll-free number).

Renewable Electricity Production Credit, Publication of Inflation Adjustment Factor and Reference Prices for Calendar Year 2002

Notice 2002–39

This notice publishes the inflation adjustment factor and reference prices for calendar year 2002 for the renewable electricity production credit under § 45(a) of the Internal Revenue Code. The 2002 inflation adjustment factor and reference prices are used in determining the availability of the credit. The 2002 inflation adjustment factor and reference prices apply to calendar year 2002 sales of kilowatt-hours of electricity produced in the United States or a possession thereof from qualified energy resources.

BACKGROUND

Section 45(a) provides that the renewable electricity production credit for any tax year is an amount equal to the product of 1.5 cents multiplied by the kilowatt-hours of specified electricity produced by the taxpayer and sold to an unrelated person during the tax year. This electricity must be produced from qualified energy resources and at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service.

Section 45(b)(1) provides that the amount of the credit determined under § 45(a) is reduced by an amount that bears the same ratio to the amount of the credit as (A) the amount by which the reference price for the calendar year in which the sale occurs exceeds 8 cents bears to (B) 3 cents. Under § 45(b)(2), the 1.5 cents in § 45(a) and the 8 cents in § 45(b)(1) are each adjusted by multiplying the amount by the inflation adjustment factor for the calendar year in which the sale occurs.

Section 45(c)(1) defines qualified energy resources as wind, closed-loop biomass, and poultry waste. Section 45(c)(3) defines a qualified facility as any

facility owned by the taxpayer that originally is placed in service after December 31, 1993 (in the case of a facility using wind to produce electricity), December 31, 1992 (in the case of a facility using closed-loop biomass to produce electricity), or December 31, 1999 (in the case of a facility using poultry waste to produce electricity), and before January 1, 2004. See § 45(d)(7) for rules relating to the inapplicability of the credit to electricity sold to utilities under certain contracts.

Section 45(d)(2)(A) requires the Secretary to determine and publish in the Federal Register each calendar year the inflation adjustment factor and the reference prices for the calendar year. The inflation adjustment factor and the reference prices for the 2001 calendar year were published in the Federal Register on May 29, 2002, (67 Fed. Reg. 37471).

Section 45(d)(2)(B) defines the inflation adjustment factor for a calendar year as the fraction the numerator of which is the GDP implicit price deflator for the preceding calendar year and the denominator of which is the GDP implicit price deflator for the calendar year 1992. The term "GDP implicit price deflator" means the most recent revision of the implicit price deflator for the gross domestic product as computed and published by the Department of Commerce before March 15 of the calendar year.

Section 45(d)(2)(C) provides that the reference price is the Secretary's determination of the annual average contract price per kilowatt hour of electricity generated from the same qualified energy resource and sold in the previous year in the United States. Only contracts entered into after December 31, 1989, are taken into account.

INFLATION ADJUSTMENT FACTOR AND REFERENCE PRICES

The inflation adjustment factor for calendar year 2002 is 1.1908. The reference prices for calendar year 2002 are 5.54 cents per kilowatt-hour for facilities producing electricity from wind energy resources and 0 cents per kilowatt-hour for facilities producing electricity from closed-loop biomass and poultry waste energy resources.

PHASE-OUT CALCULATION

Because the 2002 reference prices for electricity produced from wind, closed-loop biomass, and poultry waste energy resources do not exceed 8 cents per kilowatt hour multiplied by the inflation adjustment factor, the phaseout of the credit provided in § 45(b)(1) does not apply to electricity produced from wind, closed-loop biomass, or poultry waste energy resources sold during calendar year 2002.

CREDIT AMOUNT

As required by § 45(b)(2), the 1.5¢ amount in § 45(a)(1) is adjusted by multiplying such amount by the inflation adjustment factor for the calendar year in which the sale occurs. If any amount as increased under the preceding sentence is not a multiple of 0.1¢, such amount is rounded to the nearest multiple of 0.1¢. Under the calculation required by § 45(b)(2), the renewable electricity production credit for calendar year 2002 is 1.8¢ per kilowatt hour on the sale of electricity produced from wind energy, closed-loop biomass, and poultry waste resources.

DRAFTING INFORMATION CONTACT

The principal author of this notice is David A. Selig of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Selig at (202) 622–3040 (not a toll-free call).

Rev. Proc. 2002–34

NOTE: This revenue procedure will be reprinted as the next revision of IRS Publication 1220, *Specifications for Filing Forms 1098, 1099, 5498, and W–2G Electronically or Magnetically.*

Use this Revenue Procedure to prepare Tax Year *2002* and prior year information returns for submission to Internal Revenue Service (IRS) using any of the following:

- Electronic Filing
- Tape Cartridge
- 8mm, 4mm, and Quarter Inch Cartridges (QIC)
- 3 ½-Inch Diskette

Caution to filers:

Please read this publication carefully. Persons or businesses required to file information returns electronically or magnetically may be subject to penalties for failure to file or include correct information if they do not follow the instructions in this Revenue Procedure.

IMPORTANT NOTES:

IRS/MCC no longer accepts 9 track magnetic tape for submitting Information Returns to IRS/MCC. See Part A, Sec. 2.02. Beginning in calendar year 2004 for tax year 2003, IRS/MCC will no longer accept 8mm, 4mm, and Quarter Inch Cartridges (QIC) for filing information returns.

Table of Contents

Part E. Extensions of Time and Waivers

Part A. General

Revenue Procedures are generally revised annually to reflect legislative and form changes. Comments concerning this Revenue Procedure, or suggestions for making it more helpful, can be addressed to:

Internal Revenue Service
Martinsburg Computing Center
Attn: Information Reporting Program
230 Murall Drive
Kearneysville, WV 25430

Sec. 1. Purpose

.01 The purpose of this Revenue Procedure is to provide the specifications for filing Forms 1098, 1099, 5498, and W–2G with IRS electronically through the IRS FIRE System or magnetically, using IBM 3480, 3490, 3490E, 3590, 3590E, or AS400 compatible tape cartridges (including 4mm, 8mm & QIC), or 3 ½-inch diskettes. ***IRS/MCC no longer accepts ½-inch 9-track magnetic tape for the processing of information returns***. This Revenue Procedure must be used for the preparation of Tax Year *2002* information returns and information returns for tax years prior to *2002* ***filed beginning January 1, 2003, and received by IRS/MCC or postmarked by December 10, 2003***. Specifications for filing the following forms are contained in this Revenue Procedure.

(a) Form 1098, Mortgage Interest Statement

(b) Form 1098–E, Student Loan Interest Statement

(c) Form 1098–T, Tuition Payments Statement

(d) Form 1099–A, Acquisition or Abandonment of Secured Property

(e) Form 1099–B, Proceeds From Broker and Barter Exchange Transactions

(f) Form 1099–C, Cancellation of Debt

(g) Form 1099–DIV, Dividends and Distributions

(h) Form 1099–G, Certain Government Payments

(i) Form 1099–INT, Interest Income

(j) Form 1099–LTC, Long-Term Care and Accelerated Death Benefits

(k) Form 1099–MISC, Miscellaneous Income

(l) Form 1099–MSA, Distributions From an Archer MSA or Medicare+Choice MSA

(m) Form 1099–OID, Original Issue Discount

(n) Form 1099–PATR, Taxable Distributions Received From Cooperatives

(o) *Form 1099–Q, Qualified Tuition Program Payments (Under Section 529)*

(p) Form 1099–R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

(q) Form 1099–S, Proceeds From Real Estate Transactions

(r) Form 5498, IRA and Coverdell ESA Contribution Information

(s) Form 5498–MSA, Archer MSA or Medicare+Choice MSA Information

(t) Form W–2G, Certain Gambling Winnings

.02 All data received at IRS/MCC for processing will be given the same protection as individual income tax returns (Form 1040). IRS/MCC will process the data and determine if the records are formatted and coded according to this Revenue Procedure.

.03 Specifications for filing Forms W–2, Wage and Tax Statements, magnetically/electronically are available from the Social Security Administration (SSA) **only**. Filers can call 1–800–SSA–6270 to obtain the telephone number of the SSA Employer Service Liaison Officer for their area.

.04 IRS/MCC does **not** process Forms W–2. Paper **and/or** magnetic media for Forms W–2 must be sent to SSA. IRS/MCC does, however, process waiver requests (Form 8508) and extension of time to file requests (Form 8809) for Forms W–2 and requests for an extension of time to provide the employee copies of Forms W–2.

.05 Generally, the box numbers on the paper forms correspond with the amount codes used to file electronically/magnetically; however, if discrepancies occur, the instructions in this Revenue Procedure govern.

.06 This Revenue Procedure also provides the requirements and specifications for electronic or magnetic media filing under the Combined Federal/State Filing Program.

.07 The following Revenue Procedures and publications provide more detailed filing procedures for certain information returns:

(a) *2002 General Instructions for Forms 1099, 1098, 5498, and W–2G* and individual form instructions

(b) Publication 1179, Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099, 5498, and W–2G

(c) Publication 1239, Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, Magnetically or Electronically

(d) Publication 1187, Specifications for Filing Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, Magnetically or Electronically

(e) Publication 1245, Specifications for Filing Form W–4, Employee's Withholding Allowance Certificate, Magnetically or Electronically

.08 This Revenue Procedure supersedes Rev. Proc. 2001–32 published as Publication 1220 (Rev. 5–2001), Specifications for Filing Forms 1098, 1099, 5498, and W–2G Magnetically or Electronically.

Sec. 2. Nature of Changes—Current Year (Tax Year *2002)*

.01 In this publication, all pertinent changes for Tax Year *2002* are emphasized by the use of *italics*. Portions of text that require special attention have been **bolded**. Filers are always encouraged to read the publication in its entirety.

.02 Programming Changes

a. General

(1) 9-track magnetic tape is no longer an acceptable type of media for submitting information returns to IRS/MCC.

(2) A new field Record Sequence Number was added to Field Positions 500–507 in **all** records. The Record Sequence Number will be in Field Positions 500–507 of the "T" Record, the "A" Record(s), the "B" Record(s), the "C" Record(s), any applicable "K" Record(s), and the "F" Record.

(3) The title of Form 1099–G was changed from Certain Government Payment and Qualified State Tuition Program Payments to Certain Government Payments.

(4) The title of Form 5498 was changed from "IRA Contribution Information" to "IRA and Coverdell ESA Contribution Information."

(5) All references to Education IRAs have been changed to Coverdell ESAs.

(6) Colorado, Louisiana, Maryland, Nebraska, North Carolina and Virginia were added to the Combined Federal/State Filing Program. See Part A, Sec. 13 for the appropriate state codes.

b. Programming Changes — Transmitter "T" Record

(1) For all forms, Payment Year, Field Positions 2–5, must be incremented to update the four-digit report year (*2001 to 2002*), unless reporting prior year data.

(2) Contact Email Address was added to Field Positions 359–393.

(3) Cartridge Tape File Indicator was moved to Field Positions 394–395.

(4) Electronic File name for a Replacement File was moved to Field Positions 396–410.

(5) Transmitter's Media Number was added to Field Position 411–416.

(6) Vendor Indicator was moved to Field Position 518.

(7) Vendor Name was moved to Field Positions 519–558.

(8) Vendor Mailing Address was moved to Field Positions 559–598.

(9) Vendor City was moved to Field Positions 599–638.

(10) Vendor State was moved to Field Positions 639–640.

(11) Vendor ZIP code was moved to Field Positions 641–649.

(12) Vendor Contact Name was moved to Field Positions 650–689.

(13) Vendor Contact Phone Number and Extension was moved to Field Positions 690–704.

(14) Vendor Contact Email Address was moved and expanded to 35 positions in Field Positions 705–739.

c. Programming Changes — Payer "A" Record

(1) For all forms, Payment Year, Field Positions 2–5, must be incremented to update the four-digit report year (*2001 to 2002*), unless reporting prior year data.

(2) For Form 1099–G, Certain Government Payments, amount code 5, Qualified State Tuition Program Earnings is no longer valid.

(3) A new Form 1099–Q, Qualified Tuition Program Payments (under Section 529), was added to list of Type of Return. The code for 1099–Q is Q.

(4) The Amount Codes, Field Positions 28–39, for 1099–Q are 1 (one), Gross Distribution, 2 (two), Earnings, and 3 (three), Basis.

(5) For Form 5498, Amount Codes, Field Positions 28–39, code "B" was changed to Coverdell ESA Contributions.

d. Programming Changes — Payee "B" Record

(1) For all forms, Payment Year, Field Positions 2–5, must be incremented to update the four-digit report year (*2001 to 2002*), unless reporting prior year data.

(2) For 1099–Q, Field Position 547, Trustee to Trustee Rollover, will have a 1 (one) indicator if the reporting is a trustee to trustee rollover or a blank if it is not a trustee to trustee rollover.

(3) For 1099–Q, Field Position 548, Type of Tuition Payment, will have a 1 (one) to indicate a private payment and a 2 (two) to indicate a state payment.

(4) For 1099–Q, Field Position 549, Designated Beneficiary, will have a blank or a 1 (one) to indicate if the recipient is not the designated beneficiary.

(5) For Form 1099–R, the title for Distribution Code M, Field Positions 545–546, was changed to Distribution from a Coverdell ESA.

(6) For Form 5498, Education IRA Indicator, Field Position 552, was changed to Coverdell ESA Indicator.

e. Programming Changes — End of File "F" Record

(1) Total Number of Payees was added to Field Positions 50–57.

.03 Editorial Changes

a. In an effort to eliminate redundancy and improve clarity and organization, the Publication 1220 has undergone a major rewrite. Parts and Sections of the publication have been moved, added, deleted and/or rearranged. New information or additions to the publication have been italicized. The title of the publication was changed to Specifications for Filing Forms 1098, 1099, 5498 and W–2G Electronically or Magnetically. Actual programming changes are minor and are listed above.

b. The Information Reporting Program (IRP) Call Site was reorganized and is now the IRP Customer Service Section. The IRP Customer Service Section continues to assist filers via a toll-free number and email with information return issues. See Part A, Sec. 3.09.

c. A First Time Filers Quick Reference Guide was added to the inside cover of the publication.

d. Bullets were added to the beginning of Part A, Sec. 11, Corrected Returns to emphasize important points. A record layout was added illustrating both the two step and one step correction process.

e. Bullets were added to the beginning of Part A, Sec. 13, Combined Federal/State Filing Program to emphasize important points. A record layout was added to illustrate a file with Combined Federal/State Filing.

f. A 1099–R Distribution Code Chart which shows acceptable combinations of distribution codes was added to Part D, Sec. 6 (16).

g. Part A, Sec. 10, Replacement Media is new.

h. Part A, Sec. 14, Penalties Associated With Information Returns is new.

i. Part A, Sec. 16, Major Problems Encountered was revised.

j. Part A, Sec. 17, Definition of Terms was deleted.

k. Extension and waiver information is in Part E.

l. Beginning in calendar year 2004 for Tax Year 2003, IRS/MCC will no longer accept 8mm, 4mm, and Quarter Inch Cartridges (QIC).

Sec. 3. Where To File and How to Contact the IRS, Martinsburg Computing Center

.01 All information returns filed electronically or magnetically are processed at IRS/MCC. Files containing information returns and requests for IRS electronic and magnetic media filing information should be sent to the following address:

IRS-Martinsburg Computing Center
Information Reporting Program
230 Murall Drive
Kearneysville, WV 25430

.02 All requests for an extension of time to file information returns with IRS/MCC, or to the recipients and requests for undue hardship waivers filed on Form 8508 should be sent to the following address:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
240 Murall Drive
Kearneysville, WV 25430

.03 The telephone numbers for magnetic media inquiries or electronic submissions are:

CUSTOMER SERVICE SECTION

TOLL-FREE 1–866–455–7438 **or** *email at* *mccirp@irs.gov*

304–267–3367 — TDD
(Telecommunication Device for the Deaf)
304–264–5602 — Fax Machine

Electronic Filing — FIRE system
304–262–2400

TO OBTAIN FORMS:
1–800–TAX-FORM (1–800–829–3676)

www.irs.gov — IRS Web Site access to forms (See Note)

Note: Because the IRS processes paper forms by machine (optical character recognition equipment), you cannot file the IRS Form 1096 or Copy A of Forms 1098, 1099, 5498 or W–2G printed from the IRS Web Site.

.04 The *2002 General Instructions for Forms 1098, 1099, 5498, and W–2G* and the individual forms instructions have been included in the Publication 1220 for your convenience. The Form 1096 is used only to transmit Copy A of **paper** Forms 1099, 1098, 5498, and W–2G. If filing paper returns, follow the mailing instructions on Form 1096 and submit the paper returns to the appropriate IRS Service Center.

.05 Make requests for paper Forms 1096, 1098, 1099, 5498, and W–2G, and publications related to electronic/magnetic filing by calling the IRS toll-free number **1–800–TAX-FORM (1–800–829–3676) or on the IRS Web Site at www.irs.gov**.

.06 Questions pertaining to magnetic media filing of Forms W–2 **must** be directed to the Social Security Administration (SSA). Filers can call 1–800–SSA–6270 to obtain the phone number of the SSA Employer Service Liaison Officer for their area.

.07 Payers **should not** contact IRS/MCC if they have received a penalty notice and need additional information or are requesting an abatement of the penalty. A penalty notice contains an IRS representative's name and/or phone number for contact purposes; or the payer may be instructed to respond in writing to the address provided. IRS/MCC does **not** issue penalty notices and does **not** have the authority to abate penalties. For penalty information, refer to the Penalty section of the *2002 General Instructions for Forms 1099, 1098, 5498, and W–2G*.

.08 A taxpayer or authorized representative may request a copy of a tax return, including Form W–2 filed with a return, by submitting Form 4506, Request for Copy or Transcript of Tax Form, to IRS. This form may be obtained by calling **1–800–TAX-FORM (1–800–829–3676)**. For any questions regarding this form, call 1–800–829–1040.

.09 The Information Returns Program Customer Service Section (IRP/CSS), located at IRS/MCC, answers electronic/magnetic media, paper filing, and tax law questions from the payer community relating to the filing of business information returns (Forms 1096, 1098, 1099, 5498, 8027, W–2G, and W–4). IRP/CSS also answers questions relating to the electronic/magnetic media filing of Forms 1042–S and to the tax law criteria and paper filing instructions for Forms W–2 and W–3. Inquiries dealing with backup withholding and reasonable cause requirements due to missing and incorrect taxpayer identification numbers are also addressed by IRP/CSS. Assistance is available year-round to payers, transmitters, and employers nationwide, Monday through Friday, 8:30 a.m. to 4:30 p.m. Eastern time, by calling toll-free **1–866–455–7438** or via email at *mccirp@irs.gov*. The Telecommunications Device for the Deaf (**TDD**) toll number is **304–267–3367**. Call as soon as questions arise to avoid the busy filing seasons at the end of January and February. Recipients of information returns (payees) should continue to contact 1–800–829–1040 with any questions on how to report the information returns data on their tax returns.

.10 Form 4419, Application for Filing Information Returns Electroncially/Magnetically, Form 8809, Request for Extension of Time to File Information Returns, and Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media may be faxed to IRS/MCC at the number shown above in .03. Form 4804, Transmittal of Information Returns Filed Magnetically must always be included with media shipments.

Sec. 4. Filing Requirements

.01 The regulations under section 6011(e)(2)(A) of the Internal Revenue Code provide that any person, including a corporation, partnership, individual, estate, and trust, who is required to file 250 or more information returns must file such returns electronically/magnetically. **The 250* or more requirement applies separately for each type of return and separately to each type of corrected return.**

***Even though filers may submit up to 249 information returns on paper, IRS encourages filers to transmit those information returns electronically or magnetically.**

.02 All filing requirements that follow apply individually to each reporting entity as defined by its separate taxpayer identification number (TIN), social security number (SSN), employer identification number (EIN), individual taxpayer identification number (ITIN) or adoption taxpayer identification number (ATIN). For example, if a corporation with several branches or locations uses the same EIN, the corporation must aggregate the total volume of returns to be filed for that EIN and apply the filing requirements to each type of return accordingly.

.03 Payers who are required to submit their information returns on magnetic media may choose to submit their documents by electronic filing. Payers who submit their information returns electronically by March 31, *2003*, are considered to have satisfied the magnetic media filing requirements.

.04 IRS/MCC has one method for filing information returns electronically; see Part B.

.05 The following requirements apply separately to both originals and corrections filed electronically/magnetically:

1098 1098–E* 1098–T* 1099–A 1099–B 1099–C 1099–DIV 1099–G 1099–INT 1099–LTC 1099–MISC 1099–MSA 1099–OID 1099–PATR 1099–Q 1099–R 1099–S 5498 5498–MSA W–2G	**250 or more of any** of these forms require magnetic media filing with IRS. Filing electronically will also meet this requirement. These are stand alone documents and are not to be aggregated for purposes of determining the 250 threshold. For example, if you must file 100 Forms 1099–B and 300 Forms 1099–INT, Forms 1099–B need not to be filed electronically or magnetically since they do not meet the threshold of 250. However, Forms 1099–INT must be filed electronically or magnetically since they meet the threshold of 250.

*For Tax Year *2002*, Forms 1098–E and 1098–T may be reported on paper regardless of the 250 threshold.

.06 The above requirements do not apply if the payer establishes hardship (see Part E, Sec. 5).

Sec. 5. Vendor List

.01 IRS/MCC prepares a list of vendors who support electronic or magnetic media filing. The Vendor List (Pub. 1582) contains the names of service bureaus that will produce files via electronic filing or on the prescribed types of magnetic media. It also contains the names of vendors who provide software packages for payers who wish to produce electronic files or magnetic media on their own computer systems. This list is compiled as a courtesy and in no way implies IRS/MCC approval or endorsement.

.02 If filers meeting the filing requirements engage a service bureau to prepare media on their behalf, the filers should be careful not to report duplicate data, which may cause penalty notices to be generated.

.03 The Vendor List, Publication 1582, may be updated in print every other year. The most recently printed copy will be available by contacting IRS/MCC at our ***toll-free number 1–866–455–7438*** or by letter (see Part A, Sec. 3). The Vendor List is also available on the IRS Web Site at www.irs.gov.

.04 A vendor, who offers a software package, or has the capability to electronically file information returns, or has the ability to produce magnetic media for customers, and who would like to be included on the list must submit a letter or email to IRS/MCC. The request should include:

(a) Company name
(b) Address (include city, state, and ZIP code)
(c) Telephone number (include area code)
(d) Contact person
(e) Type(s) of service provided (*e.g.*, service bureau and/or software)
(f) Type(s) of media offered (*e.g.*, tape cartridge, 3 ½-inch diskette, or electronic filing)
(g) Type(s) of return(s)

Sec. 6. Form 4419, Application for Filing Information Returns Electronically/Magnetically

.01 Transmitters are required to submit Form 4419, Application for Filing Information Returns Electronically/Magnetically, to request authorization to file information returns with IRS/MCC. A single Form 4419 should be filed no matter how many types of returns the transmitter will be submitting electronically/magnetically. For example, if a transmitter plans to file Forms 1099–INT, one Form 4419 should be submitted. If, at a later date, another type of form (Forms 1098, 1099, 5498 and W–2G) is to be filed, the transmitter does not need to submit a new Form 4419.

☛ **Note:** ***EXCEPTIONS — An additional Form 4419 is required for filing each of the following types of returns: Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, and Form W–4, Employee's Withholding Allowance Certificate. See back of Form 4419 for detailed instructions.***

.02 Tape cartridge, diskette, and electronically filed returns may not be submitted to IRS/MCC until the application has been approved. Please read the instructions on the back of Form 4419 carefully. A Form 4419 is included in the Publication 1220 for the filer's use. This form may be photocopied. Additional forms may be obtained by calling **1–800–TAX-FORM (1–800–829–3676)**. The form is also available on the IRS Web Site at **www.irs.gov**.

.03 Upon approval, a five-character alpha/numeric Transmitter Control Code (TCC) will be assigned and included in an approval letter. The TCC **must** be coded in the Transmitter "T" Record. IRS/MCC uses the TCC to identify payer/transmitters and to track their files through the processing system. The same TCC can be used regardless of the method of filing. For example, a payer may send their production data on a tape cartridge and then later file a correction file electronically. The same TCC can be used for each filing.

.04 IRS/MCC encourages transmitters who file for multiple payers to submit one application and to use the assigned TCC for all payers. While not encouraged, multiple TCCs can be issued to payers with multiple TINs. If a transmitter uses more than one TCC to file, each TCC must be reported in separate transmissions if filing electronically or on separate media if filing magnetically.

.05 If a payer's files are prepared by a service bureau, the payer may not need to submit an application to obtain a TCC. Some service bureaus will produce files, code their own TCC in the file, and send it to IRS/MCC for the payer. Other service bureaus will prepare the file and return the file to the payer for submission to IRS/MCC. These service bureaus may require the payer to obtain a TCC, which is coded in the Transmitter "T" Record. Payers should contact their service bureaus for further information.

.06 Form 4419 may be submitted anytime during the year; however, it **must** be submitted to IRS/MCC at least 30 days before the due date of the return(s) for current year processing. This will allow IRS/MCC the minimum amount of time necessary to process and respond to applications. In the event that computer equipment or software is not compatible with IRS/MCC, a waiver may be requested to file returns on paper documents.

.07 Once a transmitter is approved to file electronically/magnetically, it is not necessary to reapply **unless**:

(a) The payer has discontinued filing electronically or magnetically for two consecutive years; the payer's TCC may have been reassigned by IRS/MCC. Payers who are aware the TCC assigned will no longer be used are requested to notify IRS/MCC so these numbers may be reassigned; **or**

(b) The payer's files were transmitted in the past by a service bureau using the service bureau's TCC, but now the payer has computer equipment compatible with that of IRS/MCC and wishes to prepare his or her own files. The payer must request a TCC by filing Form 4419.

.08 In accordance with Regulations section 1.6041–7(b), payments by separate departments of a health care carrier to providers of medical and health care services may be reported on separate returns filed electronically or magnetically. In this case, the headquarters will be considered the transmitter, and the individual departments of the company filing reports will be considered payers. A single Form 4419 covering all departments filing electronically/magnetically should be submitted. One TCC may be used for all departments.

.09 Annually, a Publication 1220 containing the current Revenue Procedure, forms, and instructions will be sent to the attention of the contact person indicated on Form 4419. Additional copies can be obtained by downloading from the IRS Web Site at *www.irs.gov* or by calling 1–800–829–3676.

.10 If **any** of the information (name, TIN or address) on the Form 4419 changes, please notify IRS/MCC in writing so the IRS/MCC database can be updated. You may use our email address (See Sec. 3,.03) for basic name and address changes. IRS/MCC does not recommend sending TIN information via email. A change in the method by which information returns are submitted is not information which needs to be updated (e.g., diskette to electronic). The transmitter should include the TCC in all correspondence.

.11 Approval to file does not imply endorsement by IRS/MCC of any computer software or of the quality of tax preparation services provided by a service bureau or software vendor.

Sec. 7. Test Files

.01 IRS/MCC encourages first time electronic or magnetic media filers to submit a test, however, test files are **required** for filers wishing to participate in the Combined Federal/State Filing Program. See Part A, Sec. 13, for further information on the Combined Federal/State Filing Program.

.02 The test file **must** consist of a sample of each type of record:

- **(a)** Transmitter "T" Record (all fields marked required must include transmitter information)
- **(b)** Payer "A" Record (must not be fictitious data)
- **(c)** Multiple Payee "B" Records (**at least 11 "B" Records per each "A" Record**)
- **(d)** End of Payer "C" Record
- **(e)** State Totals "K" Record, if participating in the Combined Federal/State Filing Program
- **(f)** End of Transmission "F" Record

(See Part D for record formats.)

.03 Use the Test Indicator "T" in Field Position 28 of the "T" Record to show this is a test file.

.04 IRS/MCC will check the file to ensure it meets the specifications of this Revenue Procedure. For current filers, sending a test file will provide the opportunity to ensure their software reflects any programming changes.

.05 Electronic tests may be submitted *November 1, 2002, through February 15, 2003*. See Part B, Sec. 4.03, for information on electronic test results.

.06 Tests submitted on magnetic media should be sent to IRS/MCC between *November 1, 2002 and December 16, 2002*. Tests must be received at MCC by December 16 in order to be processed. Magnetic media filers may begin submitting test cartridges and diskettes after October 1; however, the data will not be processed until on or after November 1. For tests filed on tape cartridge, 8mm, 4mm, quarter-inch cartridge, and 3½-inch diskette, the transmitter must include the signed Form 4804 in the same package with the corresponding magnetic media. Mark the "TEST" box in Block 1 on the form. Also, mark "TEST" on the external media label.

.07 IRS/MCC will send a letter of acknowledgment to indicate the magnetic media test results. Unacceptable magnetic media test files will receive a letter and/or documentation identifying the errors. Resubmission of magnetic media test files must be received by IRS/MCC no later than *December 16, 2002.*

Sec. 8. Filing of Information Returns Magnetically and Retention Requirements

.01 Form 4804, Transmittal of Information Returns Reported Magnetically, or a computer-generated substitute, must accompany **all** magnetic media shipments except for replacements when a 4804 is not always necessary (See Part A, Sec. 10).

.02 IRS/MCC allows for the use of computer-generated substitutes for Form 4804. The substitutes must contain all information requested on the original forms including the affidavit and signature line. Photocopies are acceptable but an original signature is required. When using computer-generated forms, be sure to mark very clearly, which tax year is being reported. This will eliminate a telephone communication from IRS/MCC to question the tax year.

.03 Form 4804 may be signed by the payer or the transmitter, service bureau, paying agent, or disbursing agent (all hereafter referred to as agent) on behalf of the payer. Failure to sign the affidavit on Form 4804 may delay processing or could result in the files being unprocessed. An agent may sign the Form 4804 if the agent has the authority to sign the affidavit under an agency agreement (either oral, written, or implied) that is valid under state law and adds the caption "FOR: (name of payer)."

.04 Although an authorized agent may sign the affidavit, the payer is responsible for the accuracy of the Form 4804 and the returns filed. The payer will be liable for penalties for failure to comply with filing requirements.

.05 Multiple types of media may be submitted in a shipment. However, submit a separate Form 4804 for each type of media.

.06 Current and prior year data may be submitted in the same shipment; however, each tax year must be on separate media, and a separate Form 4804 must be prepared to clearly indicate each tax year.

.07 Filers who have prepared their information returns in advance of the due date are encouraged to submit this information to IRS/MCC no earlier than January 1 of the year the return is due.

.08 Do not report duplicate information. If a filer submits returns electronically/magnetically, identical paper documents must not be filed. This may result in erroneous penalty notices.

.09 A self-adhesive external media label, created by the filer, must be affixed to each piece of magnetic media. For instructions on how to prepare an external media label, refer to Notice 210 in the forms section of this publication. If diskettes are used, be certain that only MS-DOS compatible operating systems were used to prepare the diskettes. **Non MS-DOS diskettes are no longer acceptable at IRS/MCC**.

.10 When submitting files include the following:

- **(a)** A **signed** Form 4804
- **(b)** External media label (created by filer) affixed to magnetic media
- **(c)** IRB Box _______of _______ labeled on outside of each package

.11 IRS/MCC will not return media after successful processing. Therefore, if the transmitter wants proof that IRS/MCC received a shipment, the transmitter should select a service with tracking capabilities or one that will provide proof of delivery. Do not use special shipping containers for mailing media to IRS/MCC. Shipping containers will not be returned.

.12 IRS/MCC will not pay for or accept "Cash-on-Delivery" or "Charge to IRS" shipments of tax information that an individual or organization is legally required to submit.

.13 Payers should retain a copy of the information returns filed with IRS or have the ability to reconstruct the data for at least 3 years from the reporting due date, with the exception of Form 1099–C. A financial entity must retain a copy of Form 1099–C, Cancellation of Debt, or have the ability to reconstruct the data required to be included on the return, for at least 4 years from the date such return is required to be filed. Whenever backup withholding is imposed, a 4-year retention is required.

Sec. 9. Due Dates

.01 The due dates for filing paper returns with IRS also apply to magnetic media. Filing of information returns is on a calendar year basis, except for Forms 5498 and 5498–MSA, which are used to report amounts contributed during or after the calendar year (but not later than April 15). The following due dates will apply to Tax Year *2002*:

Due Dates

Electronic Filing	**Magnetic Filing (See Note)**
Forms 1098, 1099, and W–2G	Forms 1098, 1099, and W–2G
Recipient Copy — January 31, 2003	Recipient Copy — January 31, 2003
IRS Copy --- March 31, 2003	IRS Copy --- February 28, 2003

Electronic/Magnetic Filing
Forms 5498 and 5498–MSA
Participant Copy — June 2, 2003*
IRS Copy --- June 2, 2003
* Participants' copy of Form 5498 for Coverdell ESA and all other Forms 5498 to furnish fair market value information — January 31, 2003

.02 If any due date falls on a Saturday, Sunday or legal holiday, the return or statement is considered timely if filed or furnished on the next day that is not a Saturday, Sunday or legal holiday.

.03 Magnetic media returns postmarked by the United States Postal Service (USPS) on or before February 28, 2003, and delivered by United States mail to the IRS/MCC after the due date, are treated as timely under the "timely mailing as timely filing" rule. Refer to the 2002 General Instructions for Forms 1099, 1098, 5498, and W–2G, When to File, located in the back of this publication for more detailed information. Notice 97–26 1997–1 C.B. 413, provides rules for determining the date that is treated as the postmark date. For items delivered by a non-designated PDS, the actual date of receipt by IRS/MCC will be used as the filing date. For items delivered by a designated PDS, but through a type of service not designated in Notice 99–41, the actual date of receipt by IRS/MCC will be used as the filing date. The timely mailing rule also applies to furnishing statements to recipients and participants.

☛ **Note: Due to security regulations at MCC, the Internal Revenue police officers will only accept media from PDSs or couriers from 7:00 a.m. to 5:00 p.m., Monday through Friday**.

.04 Use this Revenue Procedure to prepare information returns filed electronically or magnetically beginning *January 1, 2003*, and received by IRS/MCC no later than *December 10, 2003*.

Sec. 10. Replacement Media

*.**01** A replacement is an information return file sent by the filer **at the request of IRS/MCC** because of errors encountered while processing the filer's original file or correction file. After the necessary changes have been made, the entire file must be returned for processing along with the Media Tracking Slip (Form 9267) which was included in the correspondence from IRS/MCC. (**See Note.**)*

☛ ***Note: Filers should never send anything to IRS/MCC marked "Replacement" unless IRS/MCC has requested a replacement file in writing or via the FIRE System.***

*.**02** Magnetic Media filers will receive a Media Tracking Slip (Form 9267), listing, and letter detailing the reason(s) their media could not be processed. It is imperative that filers maintain backup copies and/or recreate capabilities for their information return files. Open all correspondence from IRS/MCC immediately.*

*.**03** When possible, sample records identifying errors encountered will be provided with the returned information. It is the responsibility of the transmitter to check the entire file for similar errors.*

*.**04** Before sending replacement media make certain the following items are in place:*

*(**a**) Make the required changes noted in the enclosed correspondence and check entire file for other errors.*

*(**b**) Code Transmitter "T" record, in positions 21–22 for replacement. See Part D, Sec. 3.*

*(**c**) Code Payer "A" record in position 49 with "1" for replacement file. See Part D, Sec. 4.*

*(**d**) Enclose the Form 9267, Media Tracking Slip, with your replacement media.*

*(**e**) Label your Media **"Replacement Data"** and indicate the appropriate Tax Year.*

*(**f**) Complete a new Form 4804 **if any of your information has changed.***

*.**05** Replacement files must be corrected and returned to IRS/MCC within 45 days from the date of the letter. Refer to Part B, Sec. 5 .05, for procedures for files submitted electronically. A penalty for failure to return a replacement file by the due date will be assessed if the files are not corrected and returned within the 45 days **or if filers are notified by IRS/MCC of the need for a replacement file more than two times**.* A penalty for intentional disregard of filing requirements will be assessed if a replacement file is not received. (For penalty information, refer to the Penalty section of the 2002 General Instructions for Forms 1099, 1098, 5498, and W–2G.)

Sec. 11. Corrected Returns

- A **correction** is an information return submitted by the transmitter to correct an information return that was previously submitted to and processed by IRS/MCC, but contained erroneous information.

- While we encourage you to file your corrections electronically/magnetically, you may file up to 249 paper corrections even though your originals were filed electronically or magnetically.

- **DO NOT SEND YOUR ENTIRE FILE AGAIN**. Only send the information returns in need of correction.

- Information returns omitted from the original file **must not** be coded as corrections. Submit them under a separate Payer "A" Record as original returns.

- Before creating your correction file, review the following guidelines chart carefully.

.01 The magnetic media filing requirement of information returns of 250 or more applies separately to both original and corrected returns.

E **X** **A** **M** **P** **L** **E**	If a payer has 100 Forms 1099–A to be corrected, they can be filed on paper because they fall under the 250 threshold. However, if the payer has 300 Forms 1099–B to be corrected, they must be filed electronically or magnetically because they meet the 250 threshold. If for some reason a payer cannot file the 300 corrections electronically or magnetically, to avoid penalties, a request for a waiver must be submitted before filing on paper. If a waiver is approved for original documents, any corrections for the same type of return will be covered under this waiver.

.02 Corrections should be filed **as soon as possible**. Corrections filed after August 1 may be subject to the maximum penalty of $50 per return. Corrections filed by August 1 may be subject to a lesser penalty. (For information on penalties, refer to the Penalty Section of the *2002 General Instructions for Forms 1099, 1098, 5498, and W–2G*.) However, if payers discover errors after August 1, they should file corrections, as prompt correction is a factor considered in determining whether the intentional disregard penalty should be assessed or whether a waiver of the penalty for reasonable cause may be granted. All fields must be completed with the correct information, not just the data fields needing correction. Submit corrections only for the returns filed in error, not the entire file. Furnish corrected statements to recipients as soon as possible.

☛ **Note: Do NOT resubmit your entire file as corrections. This will result in duplicate filing and erroneous notices may**

be sent to payees. Submit only those returns which need to be corrected.

.03 There are numerous types of errors, and in some cases, more than one transaction may be required to correct the initial error. If the original return was filed as an aggregate, the filers must consider this in filing corrected returns.

.04 Corrected returns may be included on the same media as original returns; however, separate "A" Records are required. Corrected returns must be identified on the Form 4804 and the external media label by indicating "Correction." If filers discover that certain information returns were omitted on their original file, they must not code these documents as corrections. The file must be coded and submitted as originals.

.05 If a payer discovers errors for prior years that affect a large number of payees, in addition to sending IRS the corrected returns and notifying the payees, a letter containing the following information should be sent to IRS/MCC:

(a) Name and address of payer
(b) Type of error (please explain clearly)
(c) Tax year
(d) Payer TIN
(e) TCC
(f) Type of Return
(g) Number of Payees
(h) Filing method, paper, electronic, or magnetic media

This information will be forwarded to the appropriate office in an attempt to prevent erroneous notices from being sent to the payees. The corrections must be submitted on actual information return documents or filed electronically/magnetically. Form 4804 must be submitted with corrected files submitted magnetically. If filing magnetically, provide the correct tax year in Block 2 of the Form 4804 and on the external media label. The Form 4804 is not required for electronic filing through the FIRE System.

.06 Prior year data, original and corrected, **must** be filed according to the requirements of this Revenue Procedure. If submitting prior year corrections, use the record format for the current year and submit on separate media. However, use the actual year designation of the correction in Field Positions 2–5 of the "T", "A", and "B" Records. If filing electronically, a separate transmission must be made for each tax year.

.07 In general, filers should submit corrections for returns filed within the last 3 calendar years (4 years if the payment is a reportable payment subject to backup withholding under section 3406 of the Code and also for Form 1099–C, Cancellation of Debt).

.08 All paper returns, whether original or corrected, must be filed with the appropriate service center.

.09 The "B" Record provides a 20-position field for the Payer's Account Number for the Payee. This number will help identify the appropriate incorrect return if more than one return is filed for a particular payee. **Do not enter a TIN in this field**. A payer's account number for the payee may be a checking account number, savings account number, serial number, or any other number assigned to the payee by the payer that will distinguish the specific account. This number should appear on the initial return and on the corrected return in order to identify and process the correction properly.

.10 The record sequence for filing corrections is the same as for original returns.

.11 Review the chart that follows. Errors normally fall under one of the two categories listed. Next to each type of error made is a list of instructions on how to file the corrected return.

Guidelines for Filing Corrected Returns Electronically/Magnetically

Error Made on the Original Return	How To File the Corrected Return
☛ **Note: References to Form 4804 apply to magnetically filed media only. Form 4804 is not required for files submitted electronically through the FIRE System.**	

Two (2) separate transactions are required to make the following corrections properly. Follow the directions for both Transactions 1 and 2. (See Note 1.)

1. Original return was filed with one or more of the following errors:	**Transaction 1:** Identify incorrect returns.
(a) No payee TIN (SSN, ITIN, ATIN or EIN) **(b)** Incorrect payee TIN **(c)** Incorrect payee name **(d)** Wrong type of indicator	**A.** Prepare a new Form 4804 that includes information related to this new file. **B.** Mark "Correction" in Block 1 of Form 4804. **C.** Prepare a new file. The first record on the file will be the Transmitter "T" Record.

Guidelines for Filing Corrected Returns Electronically/Magnetically (Continued)	
Error Made on the Original Return	How To File the Corrected Return

☛ **Note: References to Form 4804 apply to magnetically filed media only. Form 4804 is not required for files submitted electronically through the FIRE System.**

D. Make a separate "A" Record for each type of return and each payer being reported. The information in the "A" Record will be **exactly** the same as it was in the original submission with one exception; remove the "1" from Field Position 48, and set the Correction File Indicator (Field Position 50) to "1".

E. The Payee "B" Records must contain **exactly the same** information as submitted previously, **except**, insert a Corrected Return Indicator Code of "G" in Field Position 6 of the "B" Records, and enter "0" (zeros) in all payment amounts.

F. Corrected returns submitted to IRS/MCC using "G" coded "B" Records may be on the same file as those returns submitted with a "C" code; **however, separate "A" Records are required.**

G. Prepare a separate "C" Record for each type of return and each payer being reported.

H. Continue with Transaction 2 to complete the correction.

Transaction 2: Report the correct information.

A. Make a separate "A" Record for each type of return and each payer being reported. Remove the "1" in Field Position 48 and set the Correction File Indicator (Field Position 50), to "1" (one).

B. The Payee "B" Records must show the correct information as well as a Corrected Return Indicator Code of "C" in Field Position 6.

C. Corrected returns submitted to IRS/MCC using "C" coded "B" Records may be on the same file as those returns submitted with "G" codes; **however, separate "A" Records are required.**

D. Prepare a separate "C" Record for each type of return and each payer being reported.

E. The last record on the file will be the End of Transmission "F" Record.

G. Indicate "Correction" on the external media label.

☛ **Note 1: See the *2002 General Instructions for Forms 1099, 1098, 5498, and W–2G* for additional information on regulations affecting corrections and related penalties.**

File layout two step corrections

Transmitter "T" Record	*Payer "A" Record*	*"G" coded Payee "B" Record*	*"G" coded Payee "B" Record*	*End of Payer "C" Record*	*Payer "A" Record*

"C" coded Payee "B" Record	*"C" coded Payee "B" Record*	*End of Payer "C" Record*	*End of Transmission "F" Record*

One transaction is required to make the following corrections properly (See Note 2).

Guidelines for Filing Corrected Returns Electronically/Magnetically (Continued)	
Error Made on the Original Return	How To File the Corrected Return
2. Original return was filed with one or more of the following errors: **(a)** Incorrect payment amount codes in the Payer "A" Record **(b)** Incorrect payment amounts in the Payee "B" Record **(c)** Incorrect code in the distribution code field in the Payee "B" Record **(d)** Incorrect payee address **(e)** Incorrect Direct sales indicator	**A.** Prepare a new Form 4804 that includes information relating to this new file. **B.** Mark "Correction" in Block 1 of Form 4804. **C.** Prepare a new file. The first record on the file will be the Transmitter "T" Record. **D.** Make a separate "A" Record for each type of return and each payer being reported. Information in the "A" Record may be the same as it was in the original submission. However, remove the "1" in Field Position 48 and set the Correction File Indicator (Field Position 50), to "1" (one). **E.** The Payee "B" Records must show the correct record information as well as a Corrected Return Indicator Code of "G" in Field Position 6. **F.** Corrected returns submitted to IRS/MCC using "G" coded "B" Records may be on the same file as those returns submitted without the "G" coded "B" Records; however, **separate "A" Records are required**. **G.** Prepare a separate "C" Record for each type of return and each payer being reported. **H.** The last record on the file will be the End of Transmission "F" Record. **I.** Indicate "Correction" on the external media label.

*File layout **one** step corrections*

Transmitter "T" Record	*Payer "A" Record*	*"G" coded Payee "B" Record*	*"G" coded Payee "B" Record*	*End of Payer "C" Record*	*End of Transmission "F" Record*

☛ **Note 2: If a filer is correcting the name and/or TIN in addition to any errors listed in item 2 of the chart, two transactions will be required. If a filer is reporting "G" coded, "C" coded, and/or "Non-coded" (original) returns on the same media, each category must be reported under separate "A" Records.**

Sec. 12. Effect on Paper Returns and Statements to Recipients

.01 Electronic/Magnetic reporting of information returns eliminates the need to submit paper documents to the IRS. **CAUTION: Do not send Copy A of the paper forms to IRS/MCC for any forms filed electronically or magnetically**. This will result in duplicate filing; therefore, erroneous notices could be generated.

.02 Payers are responsible for providing statements to the payees as outlined in the *2002 General Instructions for Forms 1099, 1098, 5498, and W–2G*. Refer to those instructions for filing information returns on paper with the IRS and furnishing statements to recipients.

.03 Statements to recipients should be clear and legible. If the official IRS form is not used, the filer must adhere to the specifications and guidelines in Publication 1179, Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099, 5498, and W–2G.

Sec. 13. Combined Federal/State Filing Program

- Through the Combined Federal/State Filing (CF/SF) Program, IRS/MCC will forward certain original and corrected information returns filed electronically or magnetically to participating states for approved filers.
- For approval, the filer must submit a test file coded for this program. See Part A, Sec. 7, Test Files.
- For magnetic media test files, attach a letter to the Form 4804 requesting to participate in the CF/SF Program. The Form 4804 or letter is not required for tests sent electronically.
- Approved filers are sent a Form 6847, Consent for Internal Revenue Service to Release Tax Information, which must be completed and returned to IRS/MCC. A separate form is required for each payer.

.01 The Combined Federal/State Filing (CF/SF) Program was established to simplify information returns filing for the taxpayer. IRS/MCC will forward this information to participating states free of charge for approved filers. Separate reporting to those states is not necessary. The following information returns may be filed under the Combined Federal/State Filing Program:

Form 1099–DIV- - -	Dividends and Distributions
Form 1099–G- - - - -	Certain Government Payments
Form 1099–INT- - - -	Interest Income
Form 1099–MISC- -	Miscellaneous Income
Form 1099–OID- - -	Original Issue Discount
Form 1099–PATR- -	Taxable Distributions Received From Cooperatives
Form 1099–R- - - - -	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
Form 5498- - - - - - -	IRA and Coverdell ESA Contribution Information

.02 To request approval to participate, a magnetic media test file coded for this program **must** be submitted to IRS/MCC between *November l, 2002, and December 16, 2002*. Electronic test files coded for this program must be submitted between *November 1, 2002, and February 15, 2003*.

.03 Attach a letter to the Form 4804 submitted with the test file to indicate a desire to participate in the Combined Federal/State Filing Program. Test files sent electronically do not require the Form 4804 or letter. If the test file is coded for the Combined Federal/State Filing Program and is acceptable, an approval letter and Form 6847 will be sent to the filer.

.04 A test file is only required for the first year. Each record, both in the test and the actual data file, must conform to this Revenue Procedure.

.05 If the test file is acceptable, IRS/MCC will send the filer an approval letter, and a Form 6847, Consent for Internal Revenue Service to Release Tax Information, which the payer **must** complete, sign, and return to IRS/MCC before any tax information can be released to the state. Filers must write their TCC on Form 6847. .

.06 If the test file is not acceptable, IRS/MCC will send magnetic media filers a letter indicating the problems. Electronic filers must dial back within two days to the FIRE System to check the acceptability of their test file. The new test file must be received by IRS/MCC no later than December 16, 2002 for magnetic media, or February 15, 2003 for an electronically filed test.

.07 A separate Form 6847 is **required** for each payer. A transmitter may not combine payers on one Form 6847 even if acting as Attorney-in-Fact for several payers. Form 6847 may be computer-generated as long as it includes all information that is on the

original form or it may be photocopied. If the Form 6847 is signed by an Attorney-in-Fact, the written consent from the payer must clearly indicate that the Attorney-in-Fact is empowered to authorize release of the information.

.08 Only code the records for participating states and for those payers who have submitted Form 6847.

.09 Some participating states require separate notification that the payer is filing in this manner. Since IRS/MCC acts as a forwarding agent only, it is the payer's responsibility to contact the appropriate states for further information.

.10 All corrections properly coded for the Combined Federal/State Filing Program will be forwarded to the participating states.

.11 Participating states and corresponding valid state codes are listed in **Table 1** of this section. The appropriate state code **must** be entered for those documents that meet the state filing requirements; **do not use state abbreviations**.

.12 Each state's filing requirements are subject to change by the state. It is the payer's responsibility to contact the participating states to verify their criteria.

.13 Upon submission of the actual files, the transmitter must be sure of the following:

(a) All records must be coded exactly as required by this Revenue Procedure.

(b) A State Totals "K" Record(s) for each state being reported **must** follow the "C" Record.

(c) Payment amount totals and the valid participating state code must be included in the State Totals "K" Record(s).

(d) The last "K" Record **must be** followed by an "A" Record or an End of Transmission "F" Record (if this is the last record of the entire file).

Table 1. Participating States and Their Codes

State	Code	State	Code	State	Code
Alabama	01	Idaho	16	Missouri	29
Arizona	04	Indiana	18	Montana	30
Arkansas	05	Iowa	19	Nebraska	31
California	06	Kansas	20	New Jersey	34
Colorado	07	Louisiana	22	New Mexico	35
Connecticut	08	Maine	23	North Carolina	37
Delaware	10	Maryland	24	North Dakota	38
District of Columbia	11	Massachusetts	25	South Carolina	45
Georgia	13	Minnesota	27	Virginia	51
Hawaii	15	Mississippi	28	Wisconsin	55

Sample File Layout for Combined Federal/State Filer

Transmitter "T" Record	*Payer "A" Record coded with 1 in position 26*	*Payee "B" Record with state code 15 in position 747–748*	*Payee "B" Record with state code 06 in position 747–748*	*Payee "B" Record no state code*	*End of Payer "C" Record*

State Totals "K" Record for "B" records coded 15. "K" record coded 15 in positions 747–748.	*State Totals "K" Record for "B" records coded 06. "K" record coded 06 in positions 747–748.*	*End of Transmission "F" Record*

Sec. 14. Penalties Associated With Information Returns

.01 *The following penalties generally apply to the person required to file information returns. The penalties apply to electronic/magnetic media filers as well as to paper filers.*

.02 Failure To File Correct Information Returns by the Due Date (Section 6721). *If you fail to file a correct information return by the due date and you cannot show reasonable cause, you may be subject to a penalty. The penalty applies if you fail to file timely, you fail to include all information required to be shown on a return, or you include incorrect information on a return. The penalty also applies if you file on paper when you were required to file on magnetic media, you report an incorrect TIN or fail to report a TIN, or you fail to file paper forms that are machine readable.*

The amount of the penalty is based on when you file the correct information return. The penalty is:

- *$15 per information return if you correctly file within 30 days of the due date of the return (See Part A, Sec. 9 .01); maximum penalty $75,000 per year ($25,000 for small businesses).*

- *$30 per information return if you correctly file more than 30 days after the due date but by August 1; maximum penalty $150,000 per year ($50,000 for small businesses).*
- *$50 per information return if you file after August 1 or you do not file required information returns; maximum penalty $250,000 per year ($100,000 for small businesses).*

.03 *A late filing penalty may be assessed for a replacement file which is not returned by the required date. Files which require replacement more than two times will also be subject to penalty. See Part A, Sec. 10, for more information on replacement files.*

.04 Intentional disregard of filing requirements*. If any failure to file a correct information return is due to intentional disregard of the filing or correct information requirements, the penalty is at least $100 per information return with no maximum penalty.*

.05 Failure To Furnish Correct Payee Statements (Section 6722)*. For information regarding penalties which may apply to failure to furnish correct payee statements, see General Instructions for Forms 1099, 1098, 5498, and W–2G.*

Sec. 15. State Abbreviations

.01 The following state and U.S. territory abbreviations are to be used when developing the state code portion of address fields. This table provides state and territory abbreviations only, and does not represent those states participating in the Combined Federal/State Filing Program.

State	Code	State	Code	State	Code
Alabama	AL	Kentucky	KY	Northern Mariana Islands	MP
Alaska	AK	Louisiana	LA	Ohio	OH
American Samoa	AS	Maine	ME	Oklahoma	OK
Arizona	AZ	Marshall Islands	MH	Oregon	OR
Arkansas	AR	Maryland	MD	Pennsylvania	PA
California	CA	Massachusetts	MA	Puerto Rico	PR
Colorado	CO	Michigan	MI	Rhode Island	RI
Connecticut	CT	Minnesota	MN	South Carolina	SC
Delaware	DE	Mississippi	MS	South Dakota	SD
District of Columbia	DC	Missouri	MO	Tennessee	TN
Federated States of Micronesia	FM	Montana	MT	Texas	TX
Florida	FL	Nebraska	NE	Utah	UT
Georgia	GA	Nevada	NV	Vermont	VT
Guam	GU	New Hampshire	NH	Virginia	VA
Hawaii	HI	New Jersey	NJ	(U.S.) Virgin Islands	VI
Idaho	ID	New Mexico	NM	Washington	WA
Illinois	IL	New York	NY	West Virginia	WV
Indiana	IN	North Carolina	NC	Wisconsin	WI
Iowa	IA	North Dakota	ND	Wyoming	WY
Kansas	KS				

.02 Filers must adhere to the city, state, and ZIP Code format for U.S. addresses in the "B" Record. This also includes American Samoa, Federated States of Micronesia, Guam, Marshall Islands, Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

.03 For foreign country addresses, filers may use a 51 position free format which should include city, province or state, postal code, and name of country in this order. This is allowable only if a "1" (one) appears in the Foreign Country Indicator, Field Position 247, of the "B" Record.

.04 When reporting APO/FPO addresses use the following format:

EXAMPLE:

Payee Name	PVT Willard J. Doe
Mailing Address	Company F, PSC Box 100
	167 Infantry REGT
Payee City	APO (or FPO)
Payee State	AE, AA, or AP*
Payee ZIP Code	098010100

*AE is the designation for ZIPs beginning with 090–098, AA for ZIP 340, and AP for ZIPs 962–966.

Sec. 16. Major Problems Encountered

IRS/MCC encourages filers to verify the format and content of each type of record to ensure the accuracy of the data. This may eliminate the need for IRS/MCC to request replacement files. This may be important for those payers who have either had their files prepared by a service bureau or who have purchased preprogrammed software packages.

Filers who engage a service bureau to prepare media on their behalf should be careful not to report duplicate data which may generate penalty notices.

The Major Problems Encountered lists some of the most frequently encountered problems with electronic/magnetic files submitted to IRS/MCC. These problems may result in IRS/MCC requesting replacement files. Some of the problems resulted from not referring to this publication for instructions.

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1. Incorrect Format

- Multiple Files on diskettes — Each diskette must contain only **ONE** file, named **IRSTAX**. A file consists of one Transmitter "T" Record followed by a Payer "A" Record, Payee "B" Records, End of Payer "C" Record, State Totals "K" Record (if applicable for CF/SF Program), and the End of Transmission "F" Record. A file can contain multiple Payer "A" Records, but, only **one** Transmitter "T" Record. See Part D, Sec. 10, for file layout diagram.
- Invalid record length — **ALL** Records must be 750 Positions in length.
- Prior tax year data **must** be formatted in the **current** tax year format. Be sure to use the **current Revenue Procedure (Publication 1220)** for formatting prior tax year data.

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2. Unable to read tape cartridge.

Please review all tape cartridge specifications carefully (See Part C, Sections 1 and 2.)

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3. No Form 4804, Transmittal of Information Returns Reported Magnetically

Each shipment of media sent to IRS/MCC must include a signed Form 4804. More than one type of media may be sent in the same shipment, (*i.e.*, diskette, and tape cartridge) but must have a separate Form 4804 to accompany **each type of media**.

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4. Discrepancy Between IRS/MCC Totals and Totals in Payer "C" Records

The "C" Record is a summary record for a type of return for a given payer. IRS compares the total number of payees and payment amounts in the "B" records with totals in the "C" Records. The two totals **must** agree. Do **NOT** enter negative amounts except when reporting Forms 1099–B. Money amounts must be all numeric, right-justified and zero (0) filled. **Do Not Use Blanks**.

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5. The Payment Amount Fields in the "B" Record Do Not Correspond to the Amount Codes in the "A" Record

The Amount Codes used in the "A" record **MUST** correspond with the payment amount fields used in the "B" records. The amount codes must be left-justified, in ascending order with the unused positions blank. For Example: If the "B" records show payment amounts in payment amount fields 2, 4, and 7, then the "A" record must correspond with 2, 4, and 7 in the amount codes field.

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6. Incorrect TIN in Payer "A" Record

The Payer's TIN reported in positions 12–20 of the "A" record must be nine numeric characters only. **(Do Not Enter Hyphen.)** The TIN and the First Payer Name Line provided in the "A" record must correspond.

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7. Incorrect Tax Year in the Transmitter "T" Record, Payer "A" Record and the Payee "B" Records

The tax year in the transmitter, payer and payee records should reflect the tax year of the information return being reported. For prior tax year data, there must be a "P" in position 6 of the Transmitter "T" record. This position must be blank for current tax year data.

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8. Incorrect Reporting of Form W–2 Information to IRS

Form W–2 information is submitted to SSA and **not** to IRS/MCC. **Any media received at IRS/MCC that contains W–2 information will be forwarded to SSA. The filer will be notified of this action by letter**. To inquire about filing Form W–2 information magnetically/electronically, call 1–800–SSA–6270.

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9. Incorrect use of Test Indicator

When sending a test file, position 28 of the Transmitter "T" record must contain a "T", otherwise blank fill.

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10. Incorrect Format for TINs in the Payee "B" Record

TINs entered in position 12–20 of the Payee "B" record must consist of nine numerics only. **(Do Not Enter Hyphens.)** Incorrect formatting of TINs may result in a penalty.

Payers/Transmitters who submit data with missing TINs, and have taken the required steps to obtain this information are encouraged to attach a letter of explanation to the required Form 4804. This letter, however, will not prevent backup withholding notices (CP2100 and CP2100A Notices) or proposed penalties (Notice 972CG) for missing or incorrect TINs. For penalty information, refer to the Penalty section of the *2002 General Instructions* for Forms 1099, 1098, 5498, and W–2G.

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11. Distribution Codes for Form 1099–R Reported Incorrectly

For Forms 1099–R, there must be valid Distribution Code(s) in position 545–546 of the Payee "B" record. For valid codes (and combinations), see Form 1099–R Distribution Code Chart 2002 in Part D. If only one distribution code is required, it must be entered in position 545 and position 546 must be blank. A blank in position 545 is not acceptable.

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12. Incorrect Record Totals Listed on Form 4804

The Combined Total Payee Records listed on the Form 4804 (Block 6) are used in the verification process of information returns. The figure in this block **must** be the total number of payee "B" records contained on individual piece of media submitted. A separate Form 4804 should be sent for each piece of media that contains a file.

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13. Missing Correction Indicator in Payee "B" Record

When a file is submitted as a correction file, there must be a correction indictor, "G" or "C" in position 6 of the Payee "B" record. See Part A, Sec. 11.

Part B. Electronic Filing Specifications

Sec. 1. General

.01 Electronic filing of Forms 1098, 1099, 5498, and W–2G, originals, corrections, and replacements of information returns is offered as an alternative to magnetic media (tape cartridge or diskette) or paper filing, but is not a requirement. Transmitters filing electronically will fulfill the magnetic media requirements for those payers who are required to file magnetically. Payers who are under the filing threshold requirement may also file electronically. If the original file was sent magnetically, but IRS/MCC has requested a replacement file, the replacement may be transmitted electronically. Also, if the original file was submitted via magnetic media, any corrections may be transmitted electronically.

.02 All electronic filing of information returns are received at IRS/MCC via the FIRE (Filing Information Returns Electronically) System. The FIRE System can be accessed via analog and ISDN BRI connections. The system is designed to support the electronic filing of information returns only. The telephone number for electronic filing is **(304–262–2400).**

.03 The electronic filing of information returns is not affiliated with the Form 1040 electronic filing program. These two programs are totally independent, and filers must obtain separate approval to participate in each of them. All inquiries concerning the electronic filing of information returns should be directed to IRS/MCC. IRS/MCC personnel cannot answer questions or assist taxpayers in the filing of Form 1040 and will direct taxpayers, to the Customer Service toll-free number (1–800–829–1040).

.04 Files submitted to IRS/MCC electronically must be in standard ASCII code. Do not send magnetic media or paper forms with the same information as the electronically submitted files. This would create duplicate reporting resulting in penalty notices.

.05 The record formats of the "T", "A", "B", "C", "K", and "F" records are the same for both electronically and magnetically filed records. See Part D, Record Format Specifications and Record Layouts.

Sec. 2. Advantages of Filing Electronically

Some of the advantages of filing electronically are as follows:

(1) Paperless, no Form 4804 requirements.

(2) Results available within 1–2 workdays regarding the acceptability of the data transmitted. It is the filer's responsibility to dial back in and check results.

(3) Later due date than magnetic media or paper for electronically filed Forms 1098, 1099, and W–2G (refer to Part A, Sec. 9.01).

(4) Allows more attempts than magnetic media filing to correct bad files within a specific time frame before imposing penalties (refer to Part B, Sec. 5.05).

(5) Better customer service due to on-line availability of transmitter's files for research purposes.

(6) Extended period to test electronic files: November 1, 2002 to February 15, 2003.

Sec. 3. Electronic Filing Approval Procedure

.01 Filers must obtain, or already have, a Transmitter Control Code (TCC) assigned prior to submitting files electronically. (Filers who currently have a TCC for magnetic media filing will not be assigned a second TCC for electronic filing.) Refer to Part A, Sec. 6, for information on how to obtain a TCC.

.02 Once a TCC is obtained, electronic filers assign their own logon name, password and PIN (Personal Identification Number) and do not need prior or special approval. See Part B, Sec. 6, for more information on the PIN.

.03 If a filer is submitting files for more than one TCC, it is not necessary to create a separate logon and password for each TCC.

.04 For all passwords, it is the user's responsibility to remember the password and not allow the password to be compromised. Passwords are user assigned at first logon and must be 8 alpha/numerics containing at least 1 uppercase, 1 lowercase, and 1 numeric. However, if filers forget their password or PIN, call ***toll-free 1–866–455–7438*** for assistance. The FIRE System will require users to change their passwords on a yearly basis.

Sec. 4. Test Files

.01 Filers are not required to submit a test file; however, the submission of a test file is encouraged for all new electronic filers to test hardware and software. If filers wish to submit an electronic test file for Tax Year *2002* (returns to be filed in *2003*), it **must** be submitted to IRS/MCC **no earlier than** November 1, 2002, and **no later than** February 15, 2003.

.02 If a filer encounters problems while transmitting the electronic test file, contact IRS/MCC ***toll-free at 1–866–455–7438*** for assistance.

.03 Filers can verify the status of the transmitted test data by connecting to the FIRE System at **304–262–2400**. This information will be available within 1–2 workdays after the transmission is received by IRS/MCC.

.04 Form 4804 is not required for test files submitted electronically. See Part B, Sec. 6.

.05 A test file is required from filers who want approval for the Combined Federal/State Filing Program. See Part A, Sec. 13, for further details.

Sec. 5. Electronic Submissions

.01 Electronically filed information may be submitted to IRS/MCC 24 hours a day, 7 days a week. Technical assistance will be available Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern time by calling ***toll-free at 1–866–455–7438.***

.02 The FIRE System will be down from December 27, 2002, through January 7, 2003. This allows IRS/MCC to update its system to reflect current year changes.

.03 Data compression is encouraged when submitting information returns electronically. WinZip and PKZip are acceptable compression packages. UNIX COMPRESS may be acceptable; however, a test file is recommended to verify compatibility. IRS/MCC cannot accept self-extracting zip files or compressed files containing multiple files.

The time required to transmit information returns electronically will vary depending on the modem speed and the type of data compression used, if any. **The time required to transmit a file can be reduced by as much as 95 percent by using compression.**

The following are transmission rates achieved in test uploads at MCC using compressed files. The transmission rates will vary depending on the modem speeds.

Transmission Speed in bps	1000 Records	10,000 Records	100,000 Records
19.2K	34 Sec.	6 Min.	60 Min.
56K	20 Sec.	3½ Min.	33 Min.
128K (ISDN)	8 Sec.	1 Min.	10 Min.

.04 Files submitted electronically will be assigned a unique filename by the FIRE System (the users may name files anything they choose from their end). The filename assigned by the FIRE System will consist of submission type (TEST, ORIG [original], CORR [correction], and REPL [replacement]), the filer's TCC and a four digit number sequence. The sequence number will be incremented for every file sent. For example, if it is your first original file for the calendar year and your TCC is 44444, the IRS assigned filename would be ORIG.44444.0001. **Record the filename**. This information will be needed by MCC to identify the file, if assistance is required.

.05 If a file was submitted timely and is bad, the filer will have up to 60 days from the day the file was transmitted or 4 replacement attempts within that 60 day period, whichever comes first, to transmit an acceptable file. If an acceptable file is not received within 60 days or within 4 replacement attempts, then the payer could be subject to late filing penalties. This only applies to files originally sent electronically.

.06 The following definitions have been provided to help distinguish between a correction and a replacement:

- A **correction** is an information return submitted by the transmitter to correct an information return that was previously submitted to and processed by IRS/MCC, but contained erroneous information. **(See Note.)**

☛ **Note: Corrections should only be made to records that have been submitted incorrectly, not the entire file.**

- A **replacement** is an information return file sent by the filer because FILE STATUS on the FIRE System indicated the original file was bad. After the necessary changes have been made, the file must be transmitted through the FIRE System. (**See Note.)**

☛ **Note: Filers should never transmit anything to IRS/MCC as a "Replacement" file unless FILE STATUS on the FIRE System indicates the file is bad.**

.07 The TCC in the Transmitter "T" Record must be the TCC used to transmit the file; otherwise, the file will be considered an error.

Sec. 6. PIN Requirements

.01 The Form 4804 is not required for electronic files. The user will be prompted to create a PIN consisting of 10 numerics when establishing their initial logon name and password.

.02 Filers must provide some on-line information, such as, company name, contact person and telephone number, before establishing their PIN number.

.03 The PIN is required each time a file is sent electronically and is permission to release the file. An authorized agent may enter their PIN, however, the payer is responsible for the accuracy of the returns. The payer will be liable for penalties for failure to comply with filing requirements. If you forget your PIN, please call ***toll-free 1–866–455–7438*** for assistance.

.04 If the file is good, it is released for mainline processing 10 calendar days from receipt. Contact us ***toll-free 1–866–455–7438*** within this 10-day period if there is a reason the file should not be released for further processing. If the file is bad, normal replacement procedures are followed.

Sec. 7. Electronic Filing Specifications

.01 The FIRE System is designed exclusively for the filing of Forms 1042–S, 1098, 1099, 5498, 8027, W–2G and W–4.

.02 A transmitter must have a TCC before a file can be transmitted. A TCC assigned for magnetic media filing, should also be used for electronic filing.

.03 The results of the electronic transmission will be available in the File Status area of the FIRE System within 1-2 business days. It is the filer's responsibility to dial back to verify the acceptability of files submitted by checking the File Status area of the system. Forms 1042–S, 8027 and W–4 require a longer processing time.

.04 Connect to the FIRE System by dialing **304–262–2400**. This number supports analog connections from 1200bps to 56Kbps or ISDN BRI 128Kbps. The system can be accessed via Dial-up network/web browser (see Part B, Sec. 8) or communications software such as Hyperterminal, Procomm, PCAnywhere or other VT100 emulation products (see Part B, Sec.9). The Dial-up network/web browser (point-to-point) will provide an Internet-like look, however, it is not the Internet.

.01 The following are some general instructions (many of these may already be set by default in your software):

Dial-up network settings:

(a) Set dial-up server type to PPP

(b) Set network protocol to TCP/IP

(c) Disable software compression

(d) Windows NT — Disable PPP-LCP extensions by clicking the 'More' option on the 'Dial' screen, then click on 'Edit entry and modem properties' and the Server folder.

(e) Windows 2000 and XP — Disable the LCP extension by going to your Dial-up Networking Properties, Networking and Settings.

Browser settings:

(a) Browser must be capable of file uploads (*i.e.*, Internet Explorer 4.0, Netscape 2.0 or higher)

(b) Enter the URL address of *http://10.225.224.2* after you have connected via dial-up. (Remember, this is a point-to-point connection, not the Internet.)

.02 Before dialing have your TCC and EIN available.

.03 Due to the large number of communication products available, it is impossible to provide specific information on all software/hardware configurations. However, since most filers use Windows 95, 98, NT, 2000 or ME software (more current versions are similar), the following instructions are geared toward those products:

Web-like Interface

Select ***Programs***

Accessories

Communications *(Windows 98, NT, 2000)*

Dial-Up Networking

First time connecting with Dial-Up Network

(If you have logged on previously, skip to Subsequent Dial-up Network Connections.)

The first time you dial-in, you will need to configure your Dial-Up Networking.

Select ***"Make new connection"***.

Type a descriptive name for the system you are calling.

Select your modem.

Click ***"Next"***.

Enter area code ***304*** and telephone number ***262–2400.***

Click ***"Next"***.

When you receive a message that you have successfully created a new Dial-Up Networking connection, click ***"Finish"***.

Click ***"Connect"*** to dial. If you are prompted for a user name and password, complete according to local procedures; otherwise, click ***"OK"***.

When you receive the message that you have connected to our system, Click on your Web Browser ***(remember, you are not connecting via the Internet — this is a point-to-point connection).***

In the URL Address enter ***http://10.225.224.2*** and press ***ENTER.***

Subsequent Dial-Up Network Connections

Click ***"Connect"***.

If prompted for user name and password, complete according to local procedures; otherwise, click ***"OK"***.

When you receive **"Connection Complete"**, click ***"OK"***.

Click on your Web Browser ***(remember, you are not connecting via the Internet).***

In the URL Address enter ***http://10.225.224.2*** and press ***ENTER.***

First time connection to The FIRE System

(If you have logged on previously, skip to Subsequent Connections to the FIRE System.)

Click ***"Create New Account"***.

Fill out the registration form and click ***"Submit"***.

Enter your ***logon name*** (most users logon with their first and last name).

Enter your ***password*** (the password is user assigned and must be 8 alpha/numerics, containing at least 1 uppercase, 1 lowercase and 1 numeric). FIRE will force you to change the password once a year.
Complete the online survey by choosing one of the options.
Click ***"Create"***.
If you receive the message **"account created"**, click ***"OK"***.
Enter your 10 digit self-assigned PIN (Personal Identification Number) and verify.
Click ***"Submit"***.
If you receive the message **"Your PIN has been successfully created!"**, click ***"OK"***.
Read the bulletin(s) and/or click ***"Start the FIRE application"***.

Subsequent connections to The FIRE System

Click ***"Log On"***.
Enter your ***logon name*** (most users logon with their first and last name).
Enter your ***password*** (the password is user assigned and is case sensitive).

At Menu Options:
Click ***"Information Returns"***
Enter your ***TCC***:
Enter your ***EIN***:
Click ***"Submit"***.

The system will then display the company name, address, city, state, ZIP code and phone number. This information will be used to contact or send any correspondence regarding this transmission. Update as appropriate and/or Click ***"Accept"***.

Click one of the following:
Original File
Correction File
Test File
Replacement File (if you select this option, select one of the following):
FIRE Replacement (file was originally transmitted on this system)
Click file to be replaced

Magnetic Media Replacement File
Enter the alpha character from Form 9267, Media Tracking Slip, that was sent with the request for replacement file.

Click ***"Submit"***.
Enter your 10 digit PIN.
Click ***"Submit"***.
Enter the ***drive/path/filename*** of the file you want to upload or click **"Browse"** to locate the file.
Click ***"Upload"***.

When the upload is complete, the screen will display the total bytes received and tell you the name of the file you just uploaded.

If you have more files to upload for that TCC:
Click ***"File Another?"***; otherwise,
Click ***"Main Menu"***.

It is your responsibility to check the acceptability of your file; therefore, be sure to dial back into the system in 1-2 business days.

At the Main Menu:
Click ***"File Stats"***.
Enter your ***TCC***:
Enter your ***EIN***:
Click ***"Search"***.

If "Results" indicate:

"Good, Not Released" and you agree with the "Count of Payees", you are finished with this file. The file will automatically be released in 10 calendar days unless you contact us within this timeframe.

"File Released" — File has been released to our mainline processing.

"File Bad" — Correct the errors and timely resubmit the file as a "replacement".

"Not Yet Processed" — File has been received, but we do not have results available yet. Please check back in a few days.

Click on the desired file for a detailed report of your transmission.
When you are finished, click on ***Main Menu***.
Click ***"Logoff"***.
Close your Web Browser.

IMPORTANT

Go back into your Dial-Up Network and click "hang-up"; otherwise, you may stay connected and incur unnecessary phone charges.

Sec. 9. Communications Software Specifications (Text Interface)

.01 Communications software settings must be:
-No parity
-Eight data bits
-One stop bit
.02 Terminal Emulation must be VT100.
.03 Before dialing have your TCC and EIN available.
.04 Due to the large number of communication products available, it is impossible to provide specific information on all software/hardware configurations. However, since most filers use Windows 95, 98, NT, 2000 or ME software (more current versions are similar), the following instructions are geared toward those products:

Text Interface

Select ***Programs***
Accessories
Communications (*Windows 98, NT, 2000*)
Hyperterminal
The first time you log on, select ***Hyperterminal***, ***Hyperterm*** or ***Hyperterm.exe***, whichever is available on your system. Thereafter, you can just select the icon that you have saved.

A box will appear titled ***"Connection Description"***.
Enter a name and choose an icon for the connection:
Country Code: ***United States of America***
Area Code: ***304***
Phone Number: ***262–2400***

Connect Using: (default)
(If you need to modify the phone number, select ***File***, then ***Properties*** to enter defaults for the area code, phone numbers and/or special access codes.)
Click on "***Dial***."
A ***"Connect"*** box will appear to show the status.
Once you have connected to The FIRE System, if you do not get a menu within a few seconds, press the ***ENTER*** key one time.
Press ***"1"*** to connect to the system.
Read the Information notice and/or press ***ENTER*** to continue.

First Time Logon

When you have connected to the system, enter ***"new"*** to create your logon name and password.
Complete the registration information and enter ***"y"*** to create account.

Logon Name and Password

Logon Name: Enter a logon name. Most users enter their first and last name as the logon name.
Password: Enter a password (the password is user assigned and must be 8 alpha/numerics, containing at least 1 uppercase, 1 lowercase and 1 numeric). FIRE will force you to change the password once a year.
After entering the password and completing the survey, press ***ENTER***.
Enter your 10 digit self-assigned PIN (Personal Identification Number) and verify. Enter ***"y"*** to create the PIN. If successful, you will receive a message that the PIN creation has been completed. Press ***ENTER***.
Read the information notice and/or press ***ENTER***.

Transferring Your Electronic File

From the Main Menu,
Enter ***"A"*** for Electronic Filing.
Enter ***"A"*** for Forms 1098, 1099, 5498, W–2G, 1042–S, 8027 and Questionable Forms W–4.
Press the Tab key to advance to TCC box; otherwise, enter ***"E"*** to exit.
Enter your ***TCC***:
Enter your ***EIN***:

The system will then display the company name, address, city, state, ZIP code and phone number. This information will be used to contact or send correspondence (if necessary) regarding this transmission. If you need to update, enter **"n"** to correct; otherwise, enter **"y"** to accept.

Select one of the following:
"A" for an Original file
"B" for a Replacement file
"C" for a Correction file
"D" for a Test file

If you selected "B" for a replacement file, select one of the following:

"A" Replacement Files For This System
This option is to replace an original/correction file that was submitted electronically on this system but was bad and needs to be replaced. Select the file to be replaced.
"B" Magnetic media replacement files
Enter the alpha character from Form 9267, Media Tracking Slip, that was sent with the request for replacement file.

Press ***ENTER*** to continue or ***"e"*** to exit.

Enter your 10 digit PIN and press ***ENTER***.

Choose one of the following protocols (Hyperterminal is normally set to Zmodem by default):
X — Xmodem
Y — Ymodem
Z — Zmodem (Zmodem will normally give you the fastest transfer rate.)

At this point, you must start the upload from your PC.
To send a file:
Go to the hyperterminal menu bar.
Click on ***Transfer***.
Click on ***Send file***. (Be sure the protocol selected matches the protocol selected earlier. If Zmodem was selected, set to Zmodem **not** Zmodem with crash recovery.)
A box will appear titled ***"Send File"***.
Enter the drive/path/filename or click on ***Browse*** to locate your file.
Click on ***Send***.

When the upload is complete, the screen will display the total bytes received and the name IRS assigned to your file.

Press ***ENTER*** to continue.

If you have more files to send for the same TCC/EIN, enter ***"y"***; otherwise, enter ***"n"***.

It is your responsibility to check the acceptability of your file; therefore, be sure to dial back into the system in 1-2 business days.

At the Main Menu:

Enter ***"B"*** for file status.

Press the Tab key to advance to TCC box; otherwise, enter ***"E"*** to exit.

Enter your ***TCC***:

Enter your ***EIN***:

Enter ***"B"*** for the current year file results.

Tab to the appropriate file and press ***ENTER***.

If "Results" indicate:

"Good, Not Released" and you agree with the "Count of Payees", you are finished with this file. The file will automatically be released in 10 calendar days unless you contact us within this timeframe.

"File Released" — File has been released to our mainline processing.

"File Bad" — Correct the errors and timely resubmit the file as a replacement.

"Not Yet Processed" — File has been received, but we do not have results available yet. Please check back in a few days.

When you are finished, enter ***"E"*** from the Main Menu to logoff.

Enter ***"2"*** to hang-up.

Sec. 10. Modem Configuration

.01 Hardware features

(a) Enable hardware flow control

(b) Enable modem error control

(c) Enable modem compression

Sec. 11. Common Problems and Questions Associated with Electronic Filing

.01 Refer to Part A, Sec. 16, for common format errors associated with electronic/magnetic files.

.02 The following are the major non-format errors associated with electronic filing:

---

1. Transmitter does not dial back to the electronic system to determine file acceptability.

The results of your file transfer are posted to the FIRE System within two business days. It is your responsibility to verify file acceptability and, if the file contains errors, you can get an online listing of the errors. Date received and number of payee records are also displayed. If the file is good, but you do not want the file processed, you must contact IRS/MCC within 10 days from the transmission of your file.

---

2. Incorrect file is not replaced timely.

If your file is bad, correct the file and timely resubmit as a replacement.

---

3. Transmitter compresses several files into one.

Only compress one file at a time. For example, if you have 10 uncompressed files to send, compress each file separately and send 10 separate compressed files.

---

4. Transmitter sends a file and File Status indicates that the file is good, but the transmitter wants to send a replacement or correction file to replace the original/correction/replacement file.

Once a file has been transmitted, you cannot send a replacement file unless File Status indicates the file is bad (1-2 business days after file was transmitted). If you do not want us to process the file, you must first contact us ***toll-free at 1–866–455–7438*** to see if this is a possibility.

---

5. Transmitter sends an original file that is good, then sends a correction file for the entire file even though there are only a few changes.

The correction file, containing the proper coding, should only contain the records requiring correction, not the entire file.

---

6. File is formatted as EBCDIC.

All files submitted electronically must be in standard ASCII code.

---

7. Transmitter has one TCC number, but is filing for multiple companies, which EIN should be used when logging into the system to send the file?

When sending the file electronically, you will need to enter the EIN of the company assigned to the TCC. When you upload the file, it will contain the EIN's for the companies, for whom you are filing. This information will be passed forward.

---

8. Transmitter sent the wrong file, what should be done?

Call us as soon as possible ***toll-free at 1–866–455–7438, ext. 3***. We may be able to stop the file before it has been processed. **Please do not send a replacement for a file that is marked as a good file.**

.03 The following are the most common problems encountered when connecting with dial-up networking/web browser:

---

1. Transmitter is unable to connect to the FIRE System using dial-up networking.

- The user name and password should be blank when trying to connect unless it is needed by your system.
- Windows 95/98: Disable **"enable software compression"**
- Windows NT/2000: Disable both **"enable software compression"** and **"enable PPP/LCP extensions"**
- TCP/IP should be the only network protocol that is enabled.

(Make sure you are using analog lines rather than digital.)

---

2. Transmitter is connecting using dial-up networking, but is unable to bring up the URL address using the web browser.

- Proxy server should be disabled for a dial-up connection.
- **"Using a modem"** option should be selected.
- The home page should either display **http://10.225.224.2** or be set to **"about:blank"**.
- The security level should be set at medium.
- The option **"enable software compression"** should be disabled under Dial-Up Networking.

---

3. Transmitter clicks on "start the fire application", but the logon screen is displayed again.

Your browser must be set to receive **"cookies"**.

---

4. Transmitter is getting a menu when connecting with dial-up networking.

The option **"pop-up a terminal window"** should be disabled.

---

5. Transmitter cannot find the browse button to upload file.

If using Internet Explorer, you must have version 4.0 or higher. If using Netscape Navigator, it must be version 2.0 or higher.

---

6. The line is busy when dialed.

We have enough lines available that you should not get this message. Check the phone number being dialed. It should be **304–262–2400**. If you need a number such as an 8 or a 9 to access an outside line, make sure it is present. Also, some companies require an access code for long distance dialing.

---

7. I am receiving the error message "Remote PPP Peer Not Responding" or receiving a 718 error with Windows 2000 or XP.

Disable **"enable LCP Extensions"** in Dial-Up Networking. (This is located in Dial-up Networking Properties, Networking, and Settings.)

.04 The following are the most common problems encountered when connecting with hyperterminal.

---

1. Transmitter is unable to connect using hyperterminal.

- If you need a number such as an 8 or a 9 to access an outside line, make sure it is present.
- Set the terminal emulation to VT100.
- Try lowering the modem speed.
- Turn the modem off and then back on to reset it.

(Make sure you are using analog lines rather than digital.)

---

2. Transmitter is getting the message "annex command line interpreter".

Disconnect and try again. You may need to lower the modem speed if this happens several times in a row.

---

3. When trying to logon, the cursor is not in the correct box, or the menus are distorted.

The terminal emulation must be set to VT100. Also, verify that the data bits are set at 8, the stop bit is set at 1 and parity is set at None.

---

4. Transmitter was able to connect and the menu is displayed, but is unable to type anything.

Scroll lock cannot be turned on.

---

5. When transmitter connects, the menus keep scrolling and display garbage characters.

Make sure **"Use error control"** and **"Compress data"** are enabled under the Advanced Connection Settings.

---

6. Transmitter receives message "bad data packet" when the file is transmitting. What does this mean?

Your modem is having problems sending the data, so it is trying to resubmit it. Normally, if the transfer does not abort, the file will be sent successfully.

Part C. Magnetic Media Specifications

.01 Transmitters should be consistent in the use of recording codes and density on files. If the media does not meet these specifications, IRS/MCC will request a replacement file. Filers are encouraged to submit a test prior to submitting the actual file. Contact IRS/MCC for further information ***toll-free at 1–866–455–7438***. Transmitters should also check media for viruses before submitting it to IRS/MCC.

Sec. 1. Tape Cartridge Specifications

.01 In most instances, IRS/MCC can process tape cartridges that meet the following specifications:

(a) Must be IBM 3480, 3490, 3490E, 3590, 3590E or AS400 compatible.

(b) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:

(1) Tape cartridges will be ½-inch tape contained in plastic cartridges which are approximately 4-inches by 5-inches by 1-inch in dimension.

(2) Magnetic tape will be chromium dioxide particle based ½-inch tape.

(3) Cartridges must be 18-track, 36-track, 128-track or 256-track parallel (**See Note**).

(4) Cartridges will contain 37,871 CPI, 75,742 CPI, or 3590 CPI (characters per inch).

(5) Mode will be full function.

(6) The data may be compressed using EDRC (Memorex) or IDRC (IBM) compression.

(7) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used.

.02 The tape cartridge records defined in this Revenue Procedure may be blocked subject to the following:

(a) A block **must not** exceed 32,250 tape positions.

(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9s or truncated. **Do not pad a block with blanks.**

(c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item **(b)** above). The block length must be evenly divisible by 750.

(d) Records may not span blocks.

.03 Tape cartridges may be labeled or unlabeled.

.04 For the purposes of this Revenue Procedure, the following must be used:

Tape Mark:

(a) Signifies the physical end of the recording on tape.

(b) For even parity, use BCD configuration 001111 (8421).

(c) May follow the header label and precede and/or follow the trailer label.

☛ **Note: Filers should indicate on the external media label whether the cartridge is 18-track, 36-track, 128-track or 256-track.**

Sec. 2. 8mm, 4mm, and Quarter-Inch Cartridge Specifications

☛ **Note: Beginning in calendar year 2004 for Tax Year 2003, IRS/MCC will no longer accept 8mm, 4mm, and Quarter Inch Cartridges (QIC).**

.01 In most instances, IRS/MCC can process tape cartridges that meet the following specifications:

(a) General

(1) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:

- Created from an AS400 operating system only.
- Mode will be full function.
- Compressed data is not acceptable.
- Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used. However, IRS/MCC encourages the use of EBCDIC. This information must appear on the external media label affixed to the cartridge.
- A file may consist of more than one cartridge; however, no more than 250,000 documents may be transmitted per file or per cartridge. The filename, for example, IRSTAX, will contain a three digit extension. The extension will indicate the sequence of the cartridge within the file (e.g., 1 of 3, 2 of 3, and 3 of 3 will appear in the header label as IRSTAX.001, IRSTAX.002, and IRSTAX.003 on each cartridge of the file). The Transmitter "T" Record must only appear on the first cartridge. The End of Transmission "F" Record should be placed only on the last cartridge for files containing multiple cartridges.

(2) The tape cartridge records defined in this Revenue Procedure may be blocked subject to the following:

- A block **must not** exceed 32,250 tape positions.
- If the use of blocked records would result in a short block, the last block of the file may be filled with 9s or truncated.
- All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see above). The block length must be evenly divisible by 750.

- Various COPY commands have been successful; however, the **SAVE OBJECT COMMAND** is not acceptable.
- Extraneous data following the "F" Record will result in IRS/MCC requesting a replacement file. Therefore, IRS/MCC encourages transmitters to use a blank tape cartridge, rather than used cartridges, in the preparation of data when submitting information returns.
- Records may not span blocks.
- No more than 250,000 documents per cartridge and per file.

(3) For faster processing, IRS/MCC encourages transmitters to use header labeled cartridges. Filers should use IRSTAX as a filename.

(4) For the purposes of this Revenue Procedure, the following must be used:
Tape Mark:
- Signifies the physical end of the recording on tape.
- For even parity, use BCD configuration 001111 (8421).
- May follow the header label and precede and/or follow the trailer label.

(5) IRS/MCC can only read one data file on a tape. A data file is a group of records which may or may not begin with a tapemark, but must end with a trailer label. Any data beyond the trailer label cannot be read by IRS programs.

(b) 8mm cartridge specifications

(1) 8mm (.315-inch) tape cartridges will be 2½-inch by 3¾-inch.

(2) These are the **only** 8mm tape cartridges IRS/MCC can accept:

Tracks	Density	Capacity
1	20 (43245 BPI)	2.3 Gb
1	21 (45434 BPI)	5 Gb

☛ **Note: Advanced Metal Evaporated (AME) cartridges are not acceptable.**

(c) 4mm cartridge specifications

(1) 4mm (.157-inch) cartridges will be 2¼-inch by 3-inch.

(2) These are the **only** 4mm cartridges IRS/MCC can accept:

Tracks	Density	Capacity
1	19 (61000 BPI)	1.3 Gb (60 meter) DDS
1	19 (61000 BPI)	2 Gb (90 meter) DDS
1	19 (61000 BPI)	4 Gb (120 meter) DDS-2

(d) Quarter-Inch Cartridges (QIC) (1/4-inch) specifications

(1) QIC cartridges will be 4″ by 6″.

(2) These are the **only** QIC cartridges IRS/MCC accepts:

Size	Tracks	Density	Capacity
QIC-24	8/9	5 (8000 BPI)	45Mb or 60Mb
QIC-120	15	15 (10000 BPI)	120Mb or 200Mb
QIC-150	18	16 (10000 BPI)	150Mb or 250Mb
QIC-525	26	17 (16000 BPI)	525Mb
QIC-1000	30	21 (36000 BPI)	1Gb
QIC-2Gb	42	34 (40640 BPI)	2Gb

.02 IRS/MCC strongly recommends filers using 8mm, 4mm or Quarter-Inch cartridges send in test media.(See Part A, Sec. 7).

Sec. 3. 3½-Inch Diskette Specifications

.01 To be compatible, a diskette file must meet the following specifications:

(a) 3½-inches in diameter.

(b) Data **must** be recorded in standard ASCII code.

(c) Records must be a fixed length of 750 bytes per record.

(d) Delimiter character commas (,) must not be used.

(e) Positions 749 and 750 of each record have been reserved for use as carriage return/line feed (cr/lf) characters, if applicable.

(f) Filename of IRSTAX must be used. Do not enter any other data in this field. If a file will consist of more than one diskette, the filename IRSTAX will contain a three-digit extension. This extension will indicate the sequence of the diskettes within the file. For example, if the file consists of three diskettes, the first diskette will be named IRSTAX.001, the second will be IRSTAX.002, and the third will be IRSTAX.003. The first diskette, IRSTAX.001 will begin with a "T" Record and the third diskette, IRSTAX.003 will have an "F" Record at the end of the file.

(g) A diskette cannot contain multiple files. A file can have only **ONE** Transmitter "T" Record.

(h) Failure to comply with instructions will result in IRS/MCC requesting a replacement file.

(i) Diskettes must meet one of the following specifications:

Capacity	Tracks	Sides/Density	Sector Size
1.44 mb	96tpi	hd	512
1.44 mb	135tpi	hd	512

.02 IRS/MCC encourages transmitters to use blank or currently formatted diskettes when preparing files. If extraneous data follows the End of Transmission "F" Record, IRS/MCC will request a replacement file.

.03 IRS/MCC will **only** accept 3½-inch diskettes created using MS-DOS.

.04 3½-inch diskettes created on a System 36 or iSeries(AS400) are not acceptable.

.05 *Compressed data is not acceptable.*

Part D. Record Format Specifications and Record Layouts

Sec. 1. General

.01 The specifications contained in this part of the Revenue Procedure define the required formation and contents of the records to be included in the electronic or magnetic media files.

.02 A provision is made in the "B" Records for entries which are optional. If the field is not used, enter blanks to maintain a fixed record length of 750 positions. Each field description explains the intended use of specific field positions.

Sec. 2. Transmitter "T" Record — General Field Descriptions

.01 The Transmitter "T" Record identifies the entity transmitting the electronic/magnetic media file and contains information which is critical if it is necessary for IRS/MCC to contact the filer.

.02 The Transmitter "T" Record is the first record on each file and is followed by a Payer "A" Record. A file format diagram is located at the end of Part D. A replacement file will be requested by IRS/MCC if the "T" Record is not present. For transmitters with multiple diskettes, refer to Part C, Sec. 3, 3½-Inch Diskette Specifications.

.03 For all fields marked **"Required"**, the transmitter must provide the information described under Description and Remarks. For those fields not marked **"Required"**, a transmitter must allow for the field, but may be instructed to enter blanks or zeros in the indicated field positions and for the indicated length.

.04 All records must be a fixed length of 750 positions.

.05 All alpha characters entered in the "T" Record must be upper-case, except email addresses which may be case sensitive. ***Do not** use punctuation in the name and address fields.*

Record Name: Transmitter "T" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter "T."
2–5	Payment Year	4	**Required**. Enter *"2002"* (unless reporting prior year data; report the year which applies [2000, 2001, etc.] and set the Prior Year Data Indicator in field position 6).
6	Prior Year Data Indicator	1	**Required**. Enter "P" **only** if reporting prior year data; otherwise, enter blank. Do not enter a "P" if tax year is *2002*.
7–15	Transmitter's TIN	9	**Required**. Enter the transmitter's nine-digit TIN Taxpayer Identification Number. May be an EIN, SSN or ITIN.
16–20	Transmitter Control Code	5	**Required**. Enter the five character alpha/numeric Transmitter Control Code (TCC) assigned by IRS/MCC. A TCC must be obtained to file data with this program.

Record Name: Transmitter "T" Record (Continued)

Field Position	Field Title	Length	Description and Remarks
21–22	Replacement Alpha Character	2	**Required for replacement files only**. Enter the alpha/numeric character which appears immediately following the TCC number on the Media Tracking Slip (Form 9267). The Form 9267 accompanies correspondence sent by IRS/MCC when files can not be processed. This field must be blank unless a replacement file has been requested. If the file is being replaced magnetically, information is required in this field. If the file was originally sent magnetically, but the replacement is being sent electronically, the information is required in this field. Otherwise, leave blank for electronic files. Left-justify information and fill unused positions with blanks. **If this is not a replacement file, enter blanks**.
23–27	Blank	5	Enter blanks.
28	Test File Indicator	1	**Required for test files only**. Enter a "T" if this is a test file; otherwise, enter a blank.
29	Foreign Entity Indicator	1	Enter a "1" (one) if the transmitter is a foreign entity. If the transmitter is not a foreign entity, enter a blank.
30–69	Transmitter Name	40	**Required**. Enter the name of the transmitter in the manner in which it is used in normal business. Left-justify and fill unused positions with blanks.
70–109	Transmitter Name (Continuation)	40	**Required**. Enter any additional information that may be part of the name. Left-justify information and fill unused positions with blanks.
110–149	Company Name	40	**Required**. Enter the name of the company to be associated with the address where correspondence should be sent.
150–189	Company Name (Continuation)	40	Enter any additional information that may be part of the name of the company where correspondence should be sent.
190–229	Company Mailing Address	40	**Required**. Enter the mailing address where correspondence should be sent.

☛ **Note: Any correspondence relating to problem media or electronic files will be sent to this address. This should be the same address as in box 5 of Form 4804.**

For U.S. addresses, the payer city, state, and ZIP Code must be reported as a 40, 2, and 9 position field, respectively. **Filers must adhere to the correct format for the payer city, state, and ZIP Code**.

For foreign addresses, filers may use the payer city, state, and ZIP Code as a continuous 51 position field. Enter information in the following order: city, province or state, postal code, and the name of the country. When reporting a foreign address, the Foreign Entity Indicator in position 29 must contain a "1" (one).

230–269	Company City	40	**Required**. Enter the city, town, or post office where correspondence should be sent.
270–271	Company State	2	**Required**. Enter the valid U. S. Postal Service state abbreviation. Refer to the chart for valid state codes in Part A, Sec. 15.
272–280	Company ZIP Code	9	**Required**. Enter the valid nine-digit ZIP assigned by the U. S. Postal Service. If only the first five digits are known, left-justify information and fill unused positions with blanks.
281–295	Blank	15	Enter blanks.
296–303	Total Number of Payees	8	Enter the total number of Payee "B" reported in the file. Right-justify information and fill unused positions with zeros.

Record Name: Transmitter "T" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
304–343	Contact Name	40	**Required**. Enter the name of the person to be contacted if IRS/MCC encounters problems with the file or transmission.
344–358	Contact Phone Number & Extension	15	**Required**. Enter the telephone number of the person to contact regarding electronic or magnetic files. Omit hyphens. If no extension is available, left-justify information and fill unused positions with blanks. For example, the IRS/MCC *Customer Service Section* phone number of ***866–455–7438*** with an extension of **52345** would be **866455743852345**.
359–393	*Contact Email Address*	*35*	***Required if available***. *Enter the email address of the person to contact regarding electronic or magnetic files. Left-justify information. If no email address is available, enter blanks.*
394–395	*Cartridge Tape File Indicator*	*2*	***Required for tape cartridge filers only***. *Enter the letters "LS" (in uppercase only). Use of this field by filers using other types of media will be acceptable but is not required.*
396–410	*Electronic File Name For a Replacement File*	*15*	***Required***. *Use for an electronic file which "FILE STATUS" has indicated was rejected. Enter the ORIGINAL or CORRECTION electronic file name assigned by the IRS electronic FIRE system. If you are sending an original, correction, or test file, enter blanks.*

EXAMPLE: If you have sent an original file, the TCC is 44444 and it is your first original file, then the filename would be ORIG.44444.0001

411–416	*Transmitter's Media Number*	*6*	*For magnetic media filers only. Enter the number used to identify a particular piece of media.*
417–499	*Blank*	*83*	*Enter blanks.*
500–507	*Record Sequence Number*	*8*	***Required***. *Enter the number of the record as it appears within your file. The record sequence number for the "T" record will always be "1" (one), since it is the first record on your file. Each record, thereafter, must be incremented by one in ascending numerical sequence, i.e. 2, 3, 4, etc. Right-justify numbers with leading zeroes in the field. For example, the "T" record sequence number would appear as "00000001" in the field.*
508–517	*Blank*	*10*	*Enter blanks.*
518	*Vendor Indicator*	*1*	***Required***. *Enter the appropriate code from the table below to indicate if your software was provided by a vendor or produced in-house.*

Indicator	***Usage***
V	*Your software was purchased from a vendor or other source.*
I	*Your software was produced by in-house programmers.*

☛ ***Note: In-house programmer is defined as an employee or a hired contract programmer. If your software is produced in-house the following Vendor information fields are not required.***

519–558	*Vendor Name*	*40*	***Required***. *Enter the name of the company from whom you purchased your software.*
559–598	*Vendor Mailing Address*	*40*	***Required***. *Enter the mailing address.*
599–638	*Vendor City*	*40*	***Required***: *Enter the city, town, or post office.*
639–640	*Vendor State*	*2*	***Required***. *Enter the valid U.S. Postal Service state abbreviation. Refer to the chart of valid state codes in Part A, Sec. 15.*

Record Name: Transmitter "T" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
641–649	*Vendor ZIP Code*	*9*	***Required**. Enter the valid nine-digit ZIP Code assigned by the U.S. Postal Service. If only the first five digits are known, left-justify information and fill unused positions with blanks.*
650–689	*Vendor Contact Name*	*40*	***Required**. Enter the name of the person who can be contacted concerning any software questions.*
690–704	*Vendor Contact Phone Number & Extension*	*15*	***Required**. Enter the telephone number of the person to contact concerning software questions. Omit hyphens. If no extension is available, left-justify information and fill unused positions with blanks.*
705–739	*Vendor Contact Email Address*	*35*	***Required**.* Enter the email address of the person to contact concerning software questions.
740–748	*Blank*	*9*	*Enter blanks.*
749–750	Blank	2	Enter blanks, or carriage return/line feed characters (CR/LF).

Sec. 3. Transmitter "T" Record — Record Layout

Record Type	Payment Year	Prior Year Data Indicator	Transmitter's TIN	Transmitter Control Code	Replacement Alpha Character	Blank
1	2–5	6	7–15	16–20	21–22	23–27

Test File Indicator	Foreign Entity Indicator	Transmitter Name	Transmitter Name (Continuation)	Company Name	Company Name (Continuation)
28	29	30–69	70–109	110–149	150–189

Company Mailing Address	Company City	Company State	Company ZIP Code	Blank	Total Number of Payees	Contact Name
190–229	230–269	270–271	272–280	281–295	296–303	304–343

Contact Phone Number & Extension	*Contact Email Address*	*Cartridge Tape File Indicator*	*Electronic File Name For a Replacement File*	*Transmitter's Media Number*	*Blank*	*Record Sequence Number*
344–358	359–393	394–395	396–410	411–416	417–499	500–507

Blank	*Vendor Indicator*	*Vendor Name*	*Vendor Mailing Address*	*Vendor City*	*Vendor State*
508–517	518	519–558	559–598	599–638	639–640

Sec. 3. Transmitter "T" Record—Record Layout (Continued)

Vendor ZIP Code	*Vendor Contact Name*	*Vendor Contact Phone Number & Extension*	*Vendor Contact Email Address*	Blank	Blank or CR/LF
641–649	*650–689*	*690–704*	*705–739*	740–748	749–750

Sec. 4. Payer "A" Record — General Field Descriptions

.01 The Payer "A" Record identifies the person making payments, a recipient of mortgage or student loan interest payments, an educational institution, a broker, a person reporting a real estate transaction, a barter exchange, a creditor, a trustee or issuer of any IRA or MSA plan, and a lender who acquires an interest in secured property or who has a reason to know that the property has been abandoned. The payer will be held responsible for the completeness, accuracy, and timely submission of electronic/magnetic files.

.02 The second record on the file must be an "A" Record. A transmitter may include Payee "B" Records for more than one payer in a file. However, **each group** of "B" Records must be preceded by an "A" Record and followed by an End of Payer "C" Record. A single file may contain different types of returns but the types of returns **must not** be intermingled. A separate "A" Record is required for each payer and each type of return being reported.

.03 The number of "A" Records depends on the number of payers and the different types of returns being reported. Do not submit separate "A" Records for each payment amount being reported. For example, if a payer is filing Form 1099-DIV to report Amount Codes 1, 2 and 3, all three amount codes should be reported under one "A" Record, not three separate "A" Records.

.04 The maximum number of "A" Records allowed on a file is 90,000.

.05 All records must be a fixed length of 750 positions.

.06 All alpha characters entered in the "A" Record must be upper-case.

.07 For all fields marked **"Required**", the transmitter must provide the information described under Description and Remarks. For those fields not marked **"Required"**, a transmitter must allow for the field, but may be instructed to enter blanks or zeros in the indicated media position(s) and for the indicated length.

Record Name: Payer "A" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter an "A"
2–5	Payment Year	4	**Required**. Enter *"2002"* (unless reporting prior year data; report the year which applies [2000, 2001, etc.]).
6–11	Blank	6	Enter blanks.
12–20	Payer's Taxpayer Identification Number(TIN)	9	**Required**. Must be the valid nine-digit Taxpayer Identification Number assigned to the payer. **Do not enter blanks, hyphens, or alpha characters**. All zeros, ones, twos, etc., will have the effect of an incorrect TIN.

☛ **Note: For foreign entities that are not required to have a TIN, this field must be blank. However, the Foreign Entity Indicator, position 52 of the "A" Record, must be set to "1" (one).**

Field Position	Field Title	Length	Description and Remarks
21–24	Payer Name Control	4	The Payer Name Control can be obtained only from the mail label on the Package 1099 that is mailed to most payers each December. Package 1099 contains Form 7018-C, Order Blank for Forms, and the mail label on the package contains a four (4) character name control. If a Package 1099 has not been received, you can determine your name control using the following simple rules or you can leave the field blank. For a business, use the first four significant characters of the business name. Disregard the word "the" when it is the first word of the name, unless there are only two words in the name. A dash (-) and an ampersand (&) are the only acceptable special characters. Names of less than four (4) characters should be left-justified, filling the unused positions with blanks.

Record Name: Payer "A" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
25	Last Filing Indicator	1	Enter a "1" (one) if this is the **last year** this payer name and TIN will file information returns electronically, magnetically or on paper; otherwise, enter blank.
26	Combined Federal/State Filer	1	**Required for the Combined Federal/State Filing Program**. Enter "1" (one) if approved to participate in the Combined Federal/State Filing Program; otherwise, enter blank. Refer to Part A, Sec. 13, for further information.
27	Type of Return	1	**Required**. Enter the appropriate code from the table below:

Type of Return	Code
1098	3
1098-E	2
1098-T	8
1099-A	4
1099-B	B
1099-C	5
1099-DIV	1
1099-G	F
1099-INT	6
1099-LTC	T
1099-MISC	A
1099-MSA	M
1099-OID	D
1099-PATR	7
1099-Q	*Q*
1099-R	9
1099-S	S
5498	L
5498-MSA	K
W-2G	W

Field Position	Field Title	Length	Description and Remarks
28–39	Amount Codes (**See Note**)	12	**Required**. Enter the appropriate amount codes for the type of return being reported. In most cases, the box numbers on paper information returns correspond with the amount codes used to file electronically or magnetically. However, if discrepancies occur, this Revenue Procedure governs. Enter the amount codes in ascending sequence, left-justify, and fill unused positions with blanks.

☛ **Note: A type of return and an amount code must be present in every Payer "A" Record even if no money amounts are being reported. For a detailed explanation of the information to be reported in each amount code, refer to the appropriate paper instructions for each form.**

Amount Codes **Form 1098** – Mortgage Interest Statement

For Reporting Mortgage Interest Received From Payers/Borrowers (Payer of Record) on Form 1098:

Amount Code	**Amount Type**
1	Mortgage interest received from payer(s)/borrower(s)
2	Points paid on purchase of principal residence
3	Refund (or credit) of overpaid interest
4	Blank (Filer's use)

Record Name: Payer "A" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**

Field Title	Amount Code	Amount Type
Amount Codes **Form 1098-E** – Student Loan Interest	For Reporting Interest on Student Loans on Form 1098-E:	
	Amount Code	**Amount Type**
	1	Student loan interest received by lender
Amount Codes **Form 1098-T** – Tuition Payments Statement	For Reporting Tuition Payments on Form 1098-T:	
See the *2002 Instructions for Form 1098-E and T* for further information	**Amount Code**	**Amount Type**
	1	Qualified tuition and related expenses
	2	Reimbursements or refunds
	3	Scholarships or grants
Amount Codes **Form 1099-A** – Acquisition or Abandonment of Secured Property	For Reporting the Acquisition or Abandonment of Secured Property on Form 1099-A:	
See the *2002 Instructions for Forms 1099-A and 1099-C* for further information on coordination with Form 1099-C	**Amount Code**	**Amount Type**
	2	Balance of principal outstanding
	4	Fair market value of property
Amount Codes **Form 1099-B** – Proceeds From Broker and Barter Exchange Transactions	For Reporting Payments on Form 1099-B:	
	Amount Code	**Amount Type**
	2	Stocks, bonds, etc. (For forward contracts, see **Note 1.**)
	3	Bartering (Do not report negative amounts.)
	4	Federal income tax withheld (backup withholding) (Do not report negative amounts.)
	6	Profit (or loss) realized in 2002
	7	Unrealized profit (or loss) on open contracts–12/31/2001 (See **Note 2.**)
	8	Unrealized profit (or loss) on open contracts–12/31/2002 (See **Note 2.**)
	9	Aggregate profit (or loss) (See **Note 2.**)

☛ **Note 1: The payment amount field associated with Amount Code 2 may be used to report a loss from a closing transaction on a forward contract. Refer to the "B" Record — General Field Descriptions and Record Layouts, Payment Amount Fields, for instructions on reporting negative amounts.**

☛ **Note 2: Payment Amount Fields 6, 7, 8, and 9 are to be used for the reporting of regulated futures or foreign currency contracts.**

Record Name: Payer "A" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
Amount Codes **Form 1099-C** – Cancellation of Debt			For Reporting Cancellation of Debt on Form 1099-C: **Amount Code** / **Amount Type** 2 Amount of debt canceled 3 Interest, if included in Amount Code 2 7 Fair market value of property (**See Note**.)

☛ **Note: Use Amount Code 7 only if a combined Form 1099–A and 1099–C is being filed.**

Amount Codes Form **1099-DIV** – Dividends and Distributions See the *2002 Instructions for Form 1099–DIV* for further information			For Reporting Payments on Form 1099-DIV: **Amount Code** / **Amount Type** 1 Ordinary dividends 2 Total capital gains distributions 3 28% rate gain 4 Qualified 5-year gain 5 Unrecaptured section 1250 gain 6 Section 1202 gain 7 Nontaxable distributions 8 Federal income tax withheld (backup withholding) 9 Investment expenses A Foreign tax paid B Cash liquidation distribution C Noncash liquidation distribution
Amount Codes **Form 1099-G –** Certain Government Payments			For Reporting Payments on Form 1099-G: **Amount Code** / **Amount Type** 1 Unemployment compensation 2 State or local income tax refunds, credits, or offsets 4 Federal income tax withheld (backup withholding or voluntary withholding on unemployment compensation or Commodity Credit Corporation Loans, or certain crop disaster payments) 6 Taxable grants 7 Agriculture payments
Amount Codes **Form 1099-INT** – Interest Income			For Reporting Payments on Form 1099-INT: **Amount Code** / **Amount Type** 1 Interest income not included in Amount Code 3 2 Early withdrawal penalty 3 Interest on U.S. Savings Bonds and Treasury obligations 4 Federal income tax withheld (backup withholding) 5 Investment expenses 6 Foreign tax paid
Amount Codes Form 1099–LTC– Long-Term Care and Accelerated Death Benefits			For Reporting Payments in Form 1099-LTC: **Amount Code** / **Amount Type** 1 Gross long-term care benefits paid 2 Accelerated death benefits paid

Record Name: Payer "A" Record (Continued)

Field Position	Field Title	Length	Description and Remarks
Amount Codes **Form 1099-MISC** – Miscellaneous Income (**See Note 1**.)			For Reporting Payments on Form 1099-MISC:

Amount Code	Amount Type
1	Rents
2	Royalties (**See Note 2.**)
3	Other income
4	Federal income tax withheld (backup withholding or withholding on Indian gaming profits)
5	Fishing boat proceeds
6	Medical and health care payments
7	Nonemployee compensation
8	Substitute payments in lieu of dividends or interest
A	Crop insurance proceeds
B	Excess golden parachute payments
C	Gross proceeds paid to an attorney in connection with legal services

☛ **Note 1: When using the Direct Sales Indicator in position 547 of the Payee "B" Record, use Type of Return Code A and Amount Code 1 in the Payer "A" Record. All payment amount fields in the Payee "B" Record will contain zeros.**

☛ **Note 2: Do not report timber royalties under a "pay-as-cut" contract; these must be reported on Form 1099-S.**

Amount Codes **Form 1099-MSA** – Distributions From an Archer MSA or Medicare+Choice MSA

For Reporting Distributions from an Archer Medical Savings Account or Medicare+Choice MSA on Form 1099-MSA:

Amount Code	Amount Type
1	Gross distribution
2	Earnings on excess contributions
4	Fair market value of the account on date of death

Amount Codes **Form 1099-OID** – Original Issue Discount

See the *2002 Instructions for Forms 1099-INT and 1099-OID* for further reporting information

For Reporting Payments on Form 1099-OID:

Amount Code	Amount Type
1	Original issue discount for 2002
2	Other periodic interest
3	Early withdrawal penalty
4	Federal income tax withheld (backup withholding)
6	Original issue discount on U.S. Treasury Obligations
7	Investment expenses

Amount Codes **Form 1099-PATR** – Taxable Distributions Received From Cooperatives

For Reporting Payments on Form 1099–PATR:

Amount Code	Amount Type
1	Patronage dividends
2	Nonpatronage distributions
3	Per-unit retain allocations
4	Federal income tax withheld (backup withholding)
5	Redemption of nonqualified notices and retain allocations

Field Position	Field Title	Length	Description and Remarks
			Pass-Through Credits

Amount Code	Amount Type
6	For filer's use for pass-through credits
7	Investment credit
8	Work opportunity credit
9	Patron's alternative minimum tax (AMT) adjustment

Amount Codes ***Form 1099-Q*** *– Qualified Tuition Program Payments (Under Section 529)*

For Reporting Distributions or Earnings from Qualified Tuition Plan on a Form 1099-Q:

Amount Code	*Amount Type*
1	Gross distribution
2	*Earnings*
3	*Basis*

Amount Codes **Form 1099-R** – Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

For Reporting Payments on Form 1099-R:

Amount Code	Amount Type
1	Gross distribution
2	Taxable amount (**See Note 1.**)
3	Capital gain (included in Amount Code 2)
4	Federal income tax withheld
5	Employee contributions or insurance premiums
6	Net unrealized appreciation in employer's securities
8	Other
9	Total employee contributions
A	Traditional IRA/SEP/SIMPLE distribution or Roth conversion (**See Note 2.**)

☛ **Note 1: If the taxable amount cannot be determined, enter a "1" (one) in position 547 of the "B" Record. Payment Amount 2 must contain zeroes.**

☛ **Note 2: For Form 1099–R, report the Roth conversion or total amount distributed from an IRA, SEP, or SIMPLE in Payment Amount Field A (IRA/SEP/SIMPLE distribution or Roth conversion) of the Payee "B" Record, and generally, the same amount in Payment Amount Field 1 (Gross Distribution). The IRA/SEP/SIMPLE indicator should be set to "1" (one) in Field Position 548 of the Payee "B" Record.**

Amount Codes **Form 1099-S** – Proceeds From Real Estate Transactions

For Reporting Payments on Form 1099-S:

Amount Code	Amount Type
2	Gross proceeds (**See Note.**)
5	Buyer's part of real estate tax

☛ **Note: Include payments of timber royalties made under a "pay-as-cut" contract, reportable under IRC section 6050N. If timber royalties are being reported, enter "TIMBER" in the description field of the "B" Record.**

Amount Codes **Form 5498** – IRA and *Coverdell ESA Contribution Information*

For Reporting Information on Form 5498:

Amount Code	Amount Type
1	IRA contributions (other than amounts in Amount Codes 2, 3, 4, 8, 9, A and B) (**See Notes 1 and 2.**)

Record Name: Payer "A" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
			Amount Code — **Amount Type** 2 — Rollover contributions 3 — Roth conversion amount 4 — Recharacterized contributions 5 — Fair market value of account 6 — Life insurance cost included in Amount Code 1 8 — SEP contributions 9 — SIMPLE contributions A — Roth IRA contributions B — Coverdell ESA contributions

☛ **Note 1: If reporting IRA contributions for a participant in a military operation, see *2002 Instructions for Forms 1099-R and 5498.***

☛ **Note 2: Also include employee contributions to an IRA under a SEP plan but not salary reduction contributions. DO NOT include EMPLOYER contributions; these are included in *Amount Code 8.***

	Amount Codes **Form 5498** – Archer MSA or Medicare+Choice MSA Information		For Reporting Information on 5498-MSA: **Amount Code** — **Amount Type** 1 — Employee or self-employed person's MSA contributions made in *2002* and *2003* for *2002* 2 — Total contributions made in *2002* (*See current 2002 Instructions.*) 3 — Total MSA contributions made in *2003* for *2002* 4 — Rollover contributions (**See Note.**) 5 — Fair market value of Archer MSA or M+C MSA *account on December 31, 2002*

☛ **Note: This is the amount of any rollover made to this MSA in *2002* after a distribution from another MSA. For detailed information on reporting, see the *2002 Instructions for Forms 1099-MSA and 5498-MSA.***

Field Position	Field Title	Length	Description and Remarks
	Amount Codes **Form W-2G** – Certain Gambling Winnings		For Reporting Payments on Form W-2G: **Amount Code** — **Amount Type** 1 — Gross winnings 2 — Federal income tax withheld 7 — Winnings from identical wagers
40–47	Blank	8	Enter blanks.
48	Original File Indicator	1	**Required for original files only**. Enter "1" (one) if the information is original data. Otherwise, enter a blank.
49	Replacement File Indicator	1	**Required for replacement files only**. Enter "1" (one) if this file is to replace a file that IRS/MCC has informed you in writing cannot be processed or the FIRE System indicated a FILE STATUS of bad. Otherwise, enter a blank.

☛ **Note: If selecting the Replacement File Indicator in Position 49, Field Positions 48 and 50 must be blank. Only one indicator may be selected for each Payer "A" Record.**

Record Name: Payer "A" Record (Continued)

Field Position	Field Title	Length	Description and Remarks
50	Correction File Indicator	1	**Required for correction files only**. Enter "1" (one) if this file is to correct information which was previously submitted to IRS/MCC, was processed, but contained erroneous information. Any information return which was inadvertently omitted from a file must be submitted as original. Otherwise, enter a blank.
51	Blank	1	Enter a blank.
52	Foreign Entity Indicator	1	Enter a "1" (one) if the payer is a foreign entity and income is paid by the foreign entity to a U. S. resident. Otherwise, enter a blank.
53–92	First Payer Name Line	40	**Required**. Enter the name of the payer whose TIN appears in positions 12–20 of the "A" Record. Any extraneous information must be deleted. Left-justify information, and fill unused positions with blanks. (Filers should not enter a transfer agent's name in this field. Any transfer agent's name should appear in the Second Payer Name Line Field.)
93–132	Second Payer Name Line	40	If the Transfer (or Paying) Agent Indicator (position 133) contains a "1" (one), this field must contain the name of the transfer (or paying) agent. If the indicator contains a "0" (zero), this field may contain either a continuation of the First Payer Name Line or blanks. Left-justify information and fill unused positions with blanks.
133	Transfer Agent Indicator	1	**Required**. Identifies the entity in the Second Payer Name Line Field. **Code** — **Meaning** 1 — The entity in the Second Payer Name Line Field is the transfer (or paying) agent. 0 (zero) — The entity shown is **not** the transfer (or paying) agent (i.e., the Second Payer Name Line Field contains either a continuation of the First Payer Name Line Field or blanks).
134–173	Payer Shipping Address	40	**Required**. If the Transfer Agent Indicator in position 133 is a "1" (one), enter the shipping address of the transfer (or paying) agent. Otherwise, enter the **actual** shipping address of the payer. The street address should include number, street, apartment or suite number (or PO Box if mail is not delivered to street address). Left-justify information, and fill unused positions with blanks.

For U.S. addresses, the payer city, state, and ZIP Code must be reported as a 40, 2, and 9 position field, respectively. **Filers must adhere to the correct format for the payer city, state, and ZIP Code.**

For foreign addresses, filers may use the payer city, state, and ZIP Code as a continuous 51 position field. Enter information in the following order: city, province or state, postal code, and the name of the country. When reporting a foreign address, the Foreign Entity Indicator in position 52 must contain a "1" (one).

Field Position	Field Title	Length	Description and Remarks
174–213	Payer City	40	**Required**. If the Transfer Agent Indicator in position 133 is a "1" (one), enter the city, town, or post office of the transfer agent. Otherwise, enter the city, town, or post office of the payer. Left-justify information, and fill unused positions with blanks. Do not enter state and ZIP Code information in this field.
214–215	Payer State	2	**Required**. Enter the valid U.S. Postal Service state abbreviations. Refer to the chart of valid state abbreviations in Part A, Sec.15.

Record Name: Payer "A" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
216–224	Payer ZIP Code	9	**Required**. Enter the valid nine-digit ZIP Code assigned by the U.S. Postal Service. If only the first five-digits are known, left-justify information and fill the unused positions with blanks. For foreign countries, alpha characters are acceptable as long as the filer has entered a "1" (one) in the Foreign Entity Indicator, located in Field Position 52 of the "A" Record.
225–239	Payer Number & Extension	15	Enter the payer's phone number and extension.
240–499	Blank	260	Enter blanks.
500–507	*Record Sequence Number*	*8*	***Required**. Enter the number of the record as it appears within your file. The record sequence number for the "T" Record will always be "1" (one), since it is the first record on your file. Each record thereafter, must be incremented by one in ascending numerical sequence, i.e. 2, 3, 4 etc. Right-justify numbers with leading zeroes in the field. For example, the "T" Record sequence number would appear as "00000001" in the field.*
508–748	Blank	241	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Sec. 5. Payer "A" Record — Record Layout

Record Type	Payment Year	Blank	Payer TIN	Payer Name Control	Last Filing Indicator
1	2–5	6–11	12–20	21–24	25

Combined Federal/State Filer	Type of Return	Amount Codes	Blank	Original File Indicator	Replacement File Indicator	Correction File Indicator
26	27	28–39	40–47	48	49	50

Blank	Foreign Entity Indicator	First Payer Name Line	Second Payer Name Line	Transfer Agent Indicator	Payer Shipping Address
51	52	53–92	93–132	133	134–173

Payer City	Payer State	Payer ZIP Code	Payer Phone Number and Extension	Blank	*Record Sequence Number*	Blank	Blank or CR/LF
174–213	214–215	216–224	225–239	240–499	500–507	508–748	749–750

Sec. 6. Payee "B" Record — General Field Descriptions and Record Layouts

.01 The "B" Record contains the payment information from the information returns. The record layout for field positions 1 through 543 is the same for all types of returns. Field positions 544 through 750 vary for each type of return to accommodate special fields for individual forms. In the "B" Record, the filer **must** allow for all twelve Payment Amount Fields. For those fields not used, enter "0s" (zeros).

.02 The following specifications include a field in the payee records called "Name Control" in which the first four characters of the payee's surname are to be entered by the filer;

(a) If filers are unable to determine the first four characters of the surname, the Name Control Field may be left blank. Compliance with the following will facilitate IRS computer programs in identifying the correct name control:

(1) The surname of the payee whose TIN is shown in the "B" Record should always appear first. If, however, the records have been developed using the first name first, the filer must leave a blank space between the first and last names.

(2) In the case of multiple payees, only the surname of the payee whose TIN (SSN, EIN, ITIN, or ATIN) is shown in the "B" Record must be present in the First Payee Name Line. Surnames of any other payees may be entered in the Second Payee Name Line.

.03 For all fields marked **"Required"**, the transmitter must provide the information described under "Description and Remarks". For those fields not marked **"Required"**, the transmitter must allow for the field, but may be instructed to enter blanks or zeros in the indicated field position(s) and for the indicated length.

.04 All records must be a fixed length of 750 positions.

.05 A field is also provided in these specifications for Special Data Entries. This field may be used to record information required by state or local governments, or for the personal use of the filer. IRS does not use the data provided in the Special Data Entries Field; therefore, the IRS program does not check the content or format of the data entered in this field. It is the filer's option to use the Special Data Entry Field.

.06 Following the Special Data Entries Field in the "B" Record, payment fields have been allocated for State Income Tax Withheld and Local Income Tax Withheld. These fields are for the convenience of the filers. The information will not be used by IRS/MCC.

.07 Those payers participating in the Combined Federal/State Filing Program must adhere to all of the specifications in Part A, Sec. 13, to participate in this program.

.08 All alpha characters in the "B" Record must be uppercase.

.09 **Do not** use decimal points (.) to indicate dollars and cents. Payment Amount Fields must be all numerics.

Record Name: Payee "B" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter "B".
2–5	Payment Year	4	**Required**. Enter *"2002"* (unless reporting prior year data; report the year which applies [2000, 2001, etc.]).
6	Corrected Return Indicator **(See Note.)**	1	**Required for corrections only**. Indicates a corrected return. __Code__ — __Definition__ G — If this is a one-transaction correction or the first of a two-transaction correction. C — If this is the second transaction of a two-transaction correction. Blank — If this is not a return being submitted to correct information already processed by IRS.

☛ **Note: C, G, and non-coded records must be reported using separate Payer "A" Records. Refer to Part A, Sec. 11, for specific instructions on how to file corrected returns.**

Record Name: Payer "B" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
7–10	Name Control	4	If determinable, enter the first four characters of the surname of the person whose TIN is being reported in positions 12–20 of the "B" Record; otherwise, **enter blanks**. This usually is the payee. If the name that corresponds to the TIN is not included in the first or second payee name line and the correct name control is not provided, a backup withholding notice may be generated for the record. Surnames of less than four characters should be left-justified, filling the unused positions with blanks. Special characters and imbedded blanks should be removed. In the case of a business, other than a sole proprietorship, use the first four significant characters of the business name. Disregard the word "the" when it is the first word of the name, unless there are only two words in the name. A dash (-) and an ampersand (&) are the only acceptable special characters. Surname prefixes are considered, e.g., for Van Elm, the name control would be VANE. For a sole proprietorship use the name of the owner to create the name control and report the owner's name in positions 248 – 287, First Payer Name Line.

☛ **Note: Imbedded blanks, extraneous words, titles, and special characters (i.e., Mr., Mrs., Dr., period [.], apostrophe [']) should be removed from the Payee Name Lines. This information may be dropped during subsequent processing at IRS/MCC. A dash (-) and an ampersand (&) are the only acceptable special characters.**

The following examples may be helpful to filers in developing the Name Control:

Name	Name Control
Individuals:	
Jane **Brow**n	BROW
John A. **Lee**	LEE*
James P. **En**, Sr.	EN*
John **O'Nei**ll	ONEI
Mary **Van B**uren	VANB
Juan **De Je**sus	DEJE
Gloria A. **El-R**oy	EL-R
Mr. John **Smit**h	SMIT
Joe **McCa**rthy	MCCA
Pedro **Torr**es-Lopes	TORR
Maria **Lope**z Moreno**	LOPE
Binh To **La**	LA*
Nhat Thi **Pham**	PHAM
Mark **D'All**esandro	DALL
Corporations:	
The **Firs**t National Bank	FIRS
The Hideaway	THEH
A & B Cafe	A&BC
11TH Street Inc.	11TH
Sole Proprietor:	
Mark **Heml**ock	HEML
DBA The Sunshine Club	

Field Position	Field Title	Length	Description and Remarks

Partnership:

Robert Aspen and Bess Willow	ASPE
Harold Fir, Bruce Elm, and Joyce Spruce et al Ptr	FIR*

Estate:

Frank White Estate	WHIT
Estate of Sheila Blue	BLUE

Trusts and Fiduciaries:

Daisy Corporation Employee Benefit Trust	DAIS
Trust FBO The Cherryblossom Society	CHER

Exempt Organization:

Laborer's Union, AFL-CIO	LABO
St. Bernard's Methodist Church Bldg. Fund	STBE

*Name Controls of less than four significant characters must be left-justified and blank-filled.

**For Hispanic names, when two last names are shown for an individual, derive the name control from the first last name.

Field Position	Field Title	Length	Description and Remarks
11	Type of TIN	1	This field is used to identify the Taxpayer Identification Number (TIN) in positions 12–20 as either an Employer Identification Number (EIN), a Social Security Number (SSN), an Individual Taxpayer Identification Number (ITIN) or an Adoption Taxpayer Identification Number(ATIN). Enter the appropriate code from the following table:

Code	Type of TIN	Type of Account
1	EIN	A business, organization, sole proprietor, or other entity
2	SSN	An individual, including a sole proprietor
2	ITIN	An individual required to have a taxpayer identification number, but who is not eligible to obtain an SSN
2	ATIN	An adopted individual prior to the assignment of a social security number
Blank	N/A	If the type of TIN is not determinable, enter a blank.

Record Name: Payee "B" Record (Continued)			
Field Position	Field Title	Length	Description and Remarks
12–20	Payee's Taxpayer Identification Number(TIN)	9	**Required**. Enter the nine-digit Taxpayer Identification Number of the payee (SSN, ITIN, ATIN, or EIN). If an identification number has been applied for but not received, enter blanks. **Do not enter hyphens or alpha characters**. All zeros, ones, twos, etc., will have the effect of an incorrect TIN. If the TIN is not available, enter blanks. Payers who submit data with missing TINs, and have taken the required steps to obtain this information, should submit a letter with their media.

☛ **Note: If you are required to report payments made through Foreign Intermediaries and Foreign Flow-Through Entities on Form 1099, see the *2002 General Instruction for Forms 1099, 1098, 5498 and W–2G* beginning on page 13 for reporting requirements.**

Field Position	Field Title	Length	Description and Remarks
21–40	Payer's Account Number For Payee	20	Enter any number assigned by the payer to the payee (e.g., checking or savings account number). Filers are encouraged to use this field. This number helps to distinguish individual payee records and should be unique for each document. Do not use the payee's TIN since this will not make each record unique. This information is particularly useful when corrections are filed. This number will be provided with the backup withholding notification and may be helpful in identifying the branch or subsidiary reporting the transaction. Do not define data in this field in packed decimal format. If fewer than twenty characters are used, filers may either left or right-justify, filling the remaining positions with blanks.
41–44	Payer's Office Code	4	Enter office code of payer; otherwise, enter blanks. For payers with multiple locations, this field may be used to identify the location of the office submitting the information return. This code will also appear on backup withholding notices.
45–54	Blank	10	Enter blanks
	Payment Amount Fields (Must be numeric)		**Required. Filers should allow for all payment amounts. For those not used, enter zeros**. Each payment field must contain 12 numeric characters. Each payment amount must contain U.S. dollars and cents. The right-most two positions represent cents in the payment amount fields. **Do not enter dollar signs, commas, decimal points, or negative payments, except those items that reflect a loss on Form 1099-B**. Positive and negative amounts are indicated by placing a "+" (plus) or "-" (minus) sign in the left-most position of the payment amount field. A negative over punch in the units position may be used, instead of a minus sign, to indicate a negative amount. If a plus sign, minus sign, or negative over punch is not used, the number is assumed to be positive. Negative over punch cannot be used in PC created files. Payment amounts must be right-justified and unused positions must be zero-filled.
55–66	Payment Amount 1*	12	The amount reported in this field represents payments for Amount Code 1 in the "A" Record.
67–78	Payment Amount 2*	12	The amount reported in this field represents payments for Amount Code 2 in the "A" Record.
79–90	Payment Amount 3*	12	The amount reported in this field represents payments for Amount Code 3 in the "A" Record.
91–102	Payment Amount 4*	12	The amount reported in this field represents payments for Amount Code 4 in the "A" Record.
103–114	Payment Amount 5*	12	The amount reported in this field represents payments for Amount Code 5 in the "A" Record.

Record Name: Payee "B" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
115–126	Payment Amount 6*	12	The amount reported in this field represents payments for Amount Code 6 in the "A" Record.
127–138	Payment Amount 7*	12	The amount reported in this field represents payments for Amount Code 7 in the "A" Record.
139–150	Payment Amount 8*	12	The amount reported in this field represents payments for Amount Code 8 in the "A" Record.
151–162	Payment Amount 9*	12	The amount reported in this field represents payments for Amount Code 9 in the "A" Record.
163–174	Payment Amount A*	12	The amount reported in this field represents payments for Amount Code A in the "A" Record.
175–186	Payment Amount B*	12	The amount reported in this field represents payments for Amount Code B in the "A" Record.
187–198	Payment Amount C*	12	The amount reported in this field represents payments for Amount Code C in the "A" Record.

*** If there are discrepancies between the payment amount fields and the boxes on the paper forms, the instructions in this Revenue Procedure govern.**

199–246	Reserved	48	Enter blanks.
247	Foreign Country Indicator	1	**If the address of the payee is in a foreign country, enter a "1" (one) in this field**; otherwise, enter blank. When filers use this indicator, they may use a free format for the payee city, state, and ZIP Code. Enter information in the following order: city, province or state, postal code, and the name of the country. Address information must not appear in the First or Second Payee Name Line.
248–287	First Payee Name Line	40	**Required**. Enter the name of the payee (preferably surname first) whose Taxpayer Identification Number (TIN) was provided in positions 12–20 of the "B" Record. Left-justify and fill unused positions with blanks. If more space is required for the name, use the Second Payee Name Line Field. The names of any other payees may be entered in the Second Payee Name Line Field. If reporting information for a sole proprietor, the individual's name must always be present, preferably on the First Payee Name Line. The use of the business name is optional in the Second Payee Name Line Field. End the First Payee Name Line with a full word. Use appropriate spacing. Extraneous words, titles, and special characters (i.e., Mr., Mrs., Dr., period, apostrophe) should be removed from the Payee Name Lines. This information may be dropped during subsequent processing at IRS/MCC. A dash (-) and an ampersand (&) are the only acceptable special characters.

☛ **Note: If you are required to report payments made through Foreign Intermediaries and Foreign Flow-Through Entities on Form 1099, see the *2002 General Instruction for Forms 1099, 1098, 5498 and W-2G* beginning on page 13 for reporting requirements.**

288–327	Second Payee Name Line	40	If there are multiple payees (e.g., partners, joint owners, or spouses), use this field for those names not associated with the TIN provided in positions 12–20 of the "B" Record, or if not enough space was provided in the First Payee Name Line, continue the name in this field. **Do not enter address information**. It is important that filers provide as much payee information to IRS/MCC as possible to identify the payee associated with the TIN. Left-justify and fill unused positions with blanks. **See Note above in First Payee Name Line**.
328–367	Blank	40	Enter blanks.

Record Name: Payee "B" Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
368–407	Payee Mailing Address	40	**Required**. Enter mailing address of payee. Street address should include number, street, apartment or suite number (or PO Box if mail is not delivered to street address). Left-justify information and fill unused positions with blanks. This field **must not** contain any data other than the payee's mailing address.
408–447	Blank	40	Enter blanks.
448–487	Payee City	40	**Required**. Enter the city, town or post office. Left-justify information and fill the unused positions with blanks. Enter APO or FPO if applicable. Do not enter state and ZIP Code information in this field.
488–489	Payee State	2	**Required**. Enter the valid U.S. Postal Service state abbreviations for states or the appropriate postal identifier (AA, AE, or AP) described in Part A, Sec. 15.
490–498	Payee ZIP Code	9	**Required**. Enter the valid ZIP Code (nine or five digit) assigned by the U.S. Postal Service. If only the first five-digits are known, left-justify information and fill the unused positions with blanks. For foreign countries, alpha characters are acceptable as long as the filer has entered a "1" (one) in the Foreign Country Indicator, located in position 247 of the "B" Record.
499	Blank	1	Enter blank.
500–507	*Record Sequence Number*	*8*	***Required**. Enter the number of the record as it appears within your file. The record sequence number for the "T" record will always be "1" (one), since it is the first record on your file. Each record, thereafter, must be incremented by one in ascending numerical sequence, i.e. 2, 3, 4 etc. Right- justify numbers with leading zeroes in the field. For example, the "T" record sequence number would appear as "00000001" in the field.*
508–543	Blank	36	Enter Blanks.

Standard Payee "B" Record Format For All Types of Returns, Positions 1–543

Record Type	Payment Year	Corrected Return Indicator	Name Control	Type of TIN	Payee's TIN	Payer's Account Number For Payee
1	2–5	6	7–10	11	12–20	21–40

Payer's Office Code	Blank	Payment Amount 1	Payment Amount 2	Payment Amount 3	Payment Amount 4	Payment Amount 5
41–44	45–54	55–66	67–78	79–90	91–102	103–114

Payment Amount 6	Payment Amount 7	Payment Amount 8	Payment Amount 9	Payment Amount A	Payment Amount B
115–126	127–138	139–150	151–162	163–174	175–186

Standard Payee "B" Record Format For All Types of Returns, Positions 1–543 (Continued)

Payment Amount C	Reserved	Foreign Country Indicator	First Payee Name Line	Second Payee Name Line	Blank
187–198	199–246	247	248–287	288–327	328–367

Payee Mailing Address	Blank	Payee City	Payee State	Payee ZIP Code	Blank	*Record Sequence Number*	Blank
368–407	408–447	448–487	488–489	490–498	499	500–507	508–543

The following sections define the field positions for the different types of returns in the Payee "B" Record (positions 544–750):

(l) Form 1098
(2) Form 1098-E
(3) Form 1098-T
(4) Form 1099-A
(5) Form 1099-B
(6) Form 1099-C
(7) Form 1099-DIV*
(8) Form 1099-G*
(9) Form 1099-INT*
(10) Form 1099-LTC
(11) Form 1099-MISC*
(12) Form 1099-MSA
(13) Form 1099-OID*
(14) Form 1099-PATR*
(15) Form 1099-Q
(16) Form 1099-R*
(17) Form 1099-S
(18) Form 5498*
(19) Form 5498-MSA
(20) Form W-2G

* These forms may be filed through the Combined Federal/State Filing Program. IRS/MCC will forward these records to participating states for filers who have been approved for the program. See Part A, Sec. 13, for information about the program, including specific codes for the record layouts.

(1) Payee "B" Record — Record Layout Positions 544–750 for Form 1098

Field Position	Field Title	Length	Description and Remarks
544–662	Blank	119	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–748	Blank	26	Enter blanks.
749–750	Blank	2	Enter blanks, or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750
Forms 1098

Blank	Special Data Entries	Blank	Blank or CR/LF
544–662	663–722	723–748	749–750

(2) Payee "B" Record — Record Layout Positions 544–750 for Form 1098–E

Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	Origination Fees/ Capitalized Interest Indicator	1	Enter "1" (one) if the amount reported in Payment Amount Field 1 includes loan origination fees and/or capitalized interest. Otherwise, enter a blank.
548–662	Blank	115	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for the filing requirements. If this field is not utilized, enter blanks.
723–748	Blank	26	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750
Forms 1098-E

Blank	Origination Fees/ Capitalized Interest Indicator	Blank	Special Data Entries	Blank	Blank or CR/LF
544–546	547	548–662	663–722	723–748	749–750

(3) Payee "B" Record — Record Layout Positions 544–750 for Form 1098-T

Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	Half-time Student Indicator	1	Enter "1" (one) if the student was at least a half-time student during any academic period that began in 2002. Otherwise, enter a blank.
548	Graduate Student Indicator	1	Enter "1" (one) if the student is enrolled exclusively in a graduate level program. Otherwise, enter a blank.
549–662	Blank	114	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for the filing requirements. If this field is not utilized, enter blanks.
723–748	Blank	26	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750
Form 1098-T

Blank	Half-time Student Indicator	Graduate Student Indicator	Blank	Special Data Entries	Blank	Blank or CR/LF
544–546	547	548	549–662	663–722	723–748	749–750

(4) Payee "B" Record — Record Layout Positions 544–750 for Form 1099–A

Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	Personal Liability Indicator	1	Enter the appropriate indicator from the table below: **Indicator** — **Usage** 1 — Borrower was personally liable for repayment of the debt. Blank — Borrower was not personally liable for repayment of the debt.
548–555	Date of Lender's Acquisition or Knowledge of Abandonment	8	Enter the acquisition date of the secured property or the date the lender first knew or had reason to know the property was abandoned, in the format YYYYMMDD (e.g., January 5, 2002, would be 20020105). **Do not enter hyphens or slashes.**
556–594	Description of Property	39	Enter a brief description of the property. For real property, enter the address, or, if the address does not sufficiently identify the property, enter the section, lot and block. For personal property, enter the type, make and model (e.g., Car-1999 Buick Regal or Office Equipment). Enter "CCC" for crops forfeited on Commodity Credit Corporation loans. If fewer than 39 positions are required, left-justify information and fill unused positions with blanks.
595–662	Blank	68	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for the filing requirements. If this field is not utilized, enter blanks.
723–748	Blank	26	Enter blanks.
749–750	Blank	2	Enter blanks, or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750
Form 1099–A

Blank	Personal Liability Indicator	Date of Lender's Acquisition or Knowledge of Abandonment	Description of Property	Blank
544–546	547	548–555	556–594	595–662

Special Data Entries	Blank	Blank or CR/LF
663–722	723–748	749–750

(5) Payee "B" Record — Record Layout Positions 544–750 for Form 1099–B			
Field Position	**Field Title**	**Length**	**Description and Remarks**
544	Second TIN Notice (Optional)	1	Enter "2" (two) to indicate notification by IRS twice within three calendar years that the payee provided an incorrect name and/or TIN combination; otherwise, enter a blank.
545–546	Blank	2	Enter blanks.
547	Gross Proceeds Indicator	1	Enter the appropriate indicator from the following table, to identify the amount reported in Amount Code 2; otherwise, enter a blank. **Indicator** **Usage** 1 Gross proceeds 2 Gross proceeds less commissions and options premiums
548–555	Date of Sale	8	For broker transactions, enter the trade date of the transaction. For barter exchanges, enter the date when cash, property, a credit, or scrip is actually or constructively received in the format YYYYMMDD (e.g., January 5, 2002, would be 20020105). Enter blanks if this is an aggregate transaction. **Do not enter hyphens or slashes.**
556–568	CUSIP Number	13	For broker transactions only, enter the CUSIP (Committee on Uniform Security Identification Procedures) number of the item reported for Amount Code 2 (stocks, bonds, etc.). Enter blanks if this is an aggregate transaction. Enter "0s" (zeros) if the number is not available. Right-justify information and fill unused positions with blanks.
569–607	Description	39	If fewer than 39 characters are required, left-justify information and fill unused positions with blanks. For broker transactions, enter a brief description of the disposition item (e.g., 100 shares of XYZ Corp). For regulated futures and forward contracts, enter "RFC" or other appropriate description. For bartering transactions, show the services or property provided.
608–662	Blank	55	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries field.
747–748	Blank	2	Enter blanks.
749–750	Blank	2	Enter blanks, or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 1099–B

Second TIN Notice (Optional)	Blank	Gross Proceeds Indicator	Date of Sale	CUSIP Number	Description
544	545–546	547	548–555	556–568	569–607

Payee "B" Record — Record Layout Positions 544–750 for Form 1099–B (Continued)

Blank	Special Data Entries	State Income Tax Withheld	Local Income Tax Withheld	Blank	Blank or CR/LF
608–662	663–722	723–734	735–746	747–748	749–750

(6) Payee "B" Record — Record Layout Positions 544–750 for Form 1099–C

Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	Bankruptcy Indicator	1	Enter "1" (one) to indicate the debt was discharged in bankruptcy, if known. Otherwise, enter a blank.
548–555	Date Canceled	8	Enter the date the debt was canceled in the format of YYYYMMDD (e.g., January 5, 2002, would be 20020105). **Do not enter hyphens or slashes.**
556–594	Debt Description	39	Enter a description of the origin of the debt, such as student loan, mortgage, or credit card expenditure. If a combined Form 1099-C and 1099–A is being filed, also enter a description of the property.
595–662	Blank	68	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–748	Blank	26	Enter blanks.
749–750	Blank	2	Enter blanks, or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 1099-C

Blank	Bankruptcy Indicator	Date Canceled	Debt Description	Blank	Special Data Entries
544–546	547	548–555	556–594	595–662	663–722

Blank	Blank or CR/LF
723–748	749–750

(7) Payee "B" Record — Record Layout Positions 544–750 for Form 1099–DIV

Field Position	Field Title	Length	Description and Remarks
544	Second TIN Notice (Optional)	1	Enter "2" (two) to indicate notification by IRS twice within three calendar years that the payee provided an incorrect name and/or TIN combination; otherwise, enter a blank.
545–546	Blank	2	Enter blanks.
547–586	Foreign Country or U.S. Possession	40	Enter the name of the foreign country or U.S. possession to which the withheld foreign tax (Amount Code A) applies. Otherwise, enter blanks.
587–662	Blank	76	Enter blanks.

(7) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-DIV (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries Field.
747–748	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program enter the valid state code from Part A, Sec. 13, Table 1. For those payers or states not participating in this program, enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544-750 for Form 1099-DIV

Second TIN Notice (Optional)	Blank	Foreign Country or U.S. Possession	Blank	Special Data Entries
544	545–546	547–586	587–662	663–722

State Income Tax Withheld	Local Income Tax Withheld	Combined Federal/ State Code	Blank or CR/LF
723–734	735–746	747–748	749–750

(8) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-G			
Field Position	**Field Title**	**Length**	**Description and Remarks**
544–546	Blank	3	Enter blanks.
547	Trade or Business Indicator	1	Enter "1" (one) to indicate the state or local income tax refund, credit, or offset (Amount Code 2) is attributable to income tax that applies exclusively to income from a trade or business. **Indicator** — **Usage** 1 — Income tax refund applies exclusively to a trade or business. Blank — Income tax refund is a general tax refund.

(8) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-G (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
548–551	Tax Year of Refund	4	Enter the tax year for which the refund, credit, or Offset (Amount Code 2) was issued. **The tax year must reflect the tax year for which the payment was made, not the tax year of the Form 1099-G. The tax year must be in the four position format of YYYY (e.g., *1999*)**. The valid range of years for the refund is 1992 through 2001.

☛ **Note: This data is not considered prior year data since it is required to be reported in the current tax year. Do NOT enter "P" in field position 6 of the Transmitter "T" Record.**

552–662	Blank	111	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. You may enter your routing and transit number (RTN) here. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries Field.
747–748	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 13, Table 1. For those payers or states not participating in this program, enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 1099-G

Blank	Trade or Business Indicator	Tax Year of Refund	Blank	Special Data Entries	State Income Tax Withheld
544–546	547	548–551	552–662	663–722	723–734

Local Income Tax Withheld	Combined Federal/ State Code	Blank or CR/LF
735–746	747–748	749–750

(9) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-INT			
Field Position	Field Title	Length	Description and Remarks
544	Second TIN Notice (Optional)	1	Enter "2" to indicate notification by IRS twice within three calendar years that the payee provided an incorrect name and/or TIN combination; otherwise, enter a blank.
545–546	Blank	2	Enter blanks.
547–586	Foreign Country or U.S. Possession	40	Enter the name of the foreign country or U.S. possession to which the withheld foreign tax (Amount Code 6) applies. Otherwise, enter blanks.
587–662	Blank	76	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. You may enter your routing and transit number (RTN) here. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries Field.
747–748	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 13, Table 1. For those payers or states not participating in this program, enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750
for Form 1099-INT

Second TIN Notice (Optional)	Blank	Foreign Country or U.S. Possession	Blank	Special Data Entries	State Income Tax Withheld
544	545–546	547–586	587–662	663–722	723–734

Local Income Tax Withheld	Combined Federal/ State Code	Blank or CR/LF
735–746	747–748	749–750

(10) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-LTC			
Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	Type of Payment Indicator	1	Enter the appropriate indicator from the following table; otherwise, enter blanks.

(10) Payee “B” Record — Record Layout Positions 544–750 for Form 1099-LTC (Continued)

Field Position	Field Title	Length	Description and Remarks
			Indicator **Usage** 1 Per diem 2 Reimbursed amount
548–556	Social Security Number of Insured	9	**Required**. Enter the Social Security Number of the insured.
557–596	Name of Insured	40	**Required**. Enter the name of the insured.
597–636	Address of Insured	40	**Required**. Enter the address of the insured. Street address should include number, street, apartment, or suite number (or PO Box if mail is not delivered to street address). Left-justify information and fill unused positions with blanks. This field **must not** contain any data other than payee’s address.

For U.S. addresses, the payee city, state, and ZIP Code must be reported as a 40, 2, and 9 position field, respectively. **Filers must adhere to the correct format for the insured’s city, state, and ZIP Code**.

For foreign addresses, filers may use the insured’s city, state, and ZIP Code as a continuous 51 position field. Enter information in the following order: city, province or state, postal code, and the name of the country. When reporting a foreign address, the Foreign Country Indicator in position 247 must contain a “1” (one).

Field Position	Field Title	Length	Description and Remarks
637–676	City of Insured	40	**Required**. Enter the city, town, or post office. Left-justify information and fill the unused positions with blanks. Enter APO or FPO, if applicable. Do not enter state and ZIP Code information in this field.
677–678	State of Insured	2	**Required**. Enter the valid U.S. Postal Service state abbreviations for states or the appropriate postal identifier (AA, AE, or AP) described in Part A, Sec. 15.
679–687	ZIP Code of Insured	9	**Required**. Enter the valid nine-digit ZIP Code assigned by the U.S. Postal Service. If only the first five-digits are known, left-justify information and fill the unused positions with blanks. For foreign countries, alpha characters are acceptable as long as the filer has entered a “1” (one) in the Foreign Country Indicator, located in position 247 of the “B” Record.
688	Status of Illness Indicator (Optional)	1	Enter the appropriate code from the table below to indicate the status of the illness of the insured; otherwise, enter blank: **Indicator** **Usage** 1 Chronically ill 2 Terminally ill
689–696	Date Certified (Optional)	8	Enter the latest date of a doctor’s certification of the status of the insured’s illness. The format of the date is YYYYMMDD (e.g., January 5, 2002, would be 20020105). **Do not enter hyphens or slashes.**
697	Qualified Contract (Optional)	1	Enter a “1” (one) if benefits were from a qualified long-term care insurance contract; otherwise, enter blank.
698–722	Blank	25	Enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled.

(10) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-LTC (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
747–748	Blank	2	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 1099-LTC

Blank	Type of Payment Indicator	SSN of Insured	Name of Insured	Address of Insured	City of Insured	State of Insured	ZIP Code of Insured
544–546	547	548–556	557–596	597–636	637–676	677–678	679–687

Status of Illness Indicator (Optional)	Date Certified (Optional)	Qualified Contract Indicator (Optional)	Blank	State Income Tax Withheld	Local Income Tax Withheld
688	689–696	697	698–722	723–734	735–746

Blank	Blank or CR/LF
747–748	749–750

(11) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-MISC			
Field Position	**Field Title**	**Length**	**Description and Remarks**
544	Second TIN Notice (Optional)	1	Enter "2" to indicate notification by IRS twice within three calendar years that the payee provided an incorrect name and/or TIN combination; otherwise, enter a blank.
545–546	Blank	2	Enter blanks.
547	Direct Sales Indicator (**See Note.**)	1	Enter a "1" (one) to indicate sales of $5,000 or more of consumer products to a person on a buy-sell, deposit-commission, or any other commission basis for resale anywhere other than in a permanent retail establishment. Otherwise, enter a blank.

☛ **Note: If reporting a direct sales indicator only, use Type of Return "A" in Field Position 27 and Amount Code 1 in Field Position 28 of the Payer "A" Record. All payment amount fields in the Payee "B" Record will contain zeros.**

548–662	Blank	115	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not used, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.

(11) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-MISC (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries Field.
747–748	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 13, Table 1. For those payers or states not participating in this program, enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 1099-MISC

Second TIN Notice (Optional)	Blank	Direct Sales Indicator	Blank	Special Data Entries	State Income Tax Withheld	Local Income Tax Withheld
544	545–546	547	548–662	663–722	723–734	735–746

Combined Federal/ State Code	Blank or CR/LF
747–748	749–750

(12) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-MSA			
Field Position	**Field Title**	**Length**	**Description and Remarks**
544	Blank	1	Enter blank.
545	Distribution Code	1	**Required**. Enter the applicable code to indicate the type of payment: **Code** **Category** 1 Normal distribution 2 Excess contribution 3 Disability 4 Death distribution other than code 6 (This includes distributions to a spouse, nonspouse, or estate beneficiary in the year of death and to an estate after the year of death.) 5 Prohibited transaction 6 Death distribution **after year of death** to a nonspouse beneficiary (Do not use for distribution to an estate.)
546	Blank	1	Enter a blank.
547	Medicare+Choice MSA Indicator	1	Enter "1" (one) if distributions are from a Medicare+Choice MSA. Otherwise, enter a blank.
548–662	Blank	115	Enter blanks.

(12) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-MSA (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries Field.
747–748	Blank	2	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750
for Form 1099-MSA

Blank	Distribution Code	Blank	Medicare+ Choice MSA Indicator	Blank	Special Data Entries
544	545	546	547	548–662	663–722

State Income Tax Withheld	Local Income Tax Withheld	Blank	Blank or CR/LF
723–734	735–746	747–748	749–750

(13) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-OID			
Field Position	**Field Title**	**Length**	**Description and Remarks**
544	Second TIN (Optional)	1	Enter "2" to indicate notification by IRS twice within three calendar years that the payee provided an incorrect name and/or TIN combination; otherwise, enter a blank.
545–546	Blank	2	Enter blanks.
547–585	Description	39	**Required**. Enter the CUSIP number, if any. If there is no CUSIP number, enter the abbreviation for the stock exchange and issuer, the coupon rate, and year (**must be 4-digit year**) of maturity (e.g., NYSE XYZ 12 / *2002*). Show the name of the issuer if other than the payer. If fewer than 39 characters are required, left-justify information and fill unused positions with blanks.
586–662	Blank	77	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.

(13) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-OID (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries Field.
747–748	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 13, Table 1. For those payers or states not participating in this program, enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 1099-OID

Second TIN Notice (Optional)	Blank	Description	Blank	Special Data Entries	State Income Tax Withheld
544	545–546	547–585	586–662	663–722	723–734

Local Income Tax Withheld	Combined Federal/ State Code	Blank or CR/LF
735–746	747–748	749–750

(14) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-PATR			
Field Position	**Field Title**	**Length**	**Description and Remarks**
544	Second TIN Notice (Optional)	1	Enter "2" (two) to indicate notification by IRS twice within three calendar years that the payee provided an incorrect name and/or TIN combination; otherwise, enter a blank.
545–662	Blank	118	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.

(14) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-PATR (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries Field.
747–748	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 13, Table 1. For those payers or states not participating in this program, enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for 1099-PATR

Second TIN Notice (Optional)	Blank	Special Data Entries	State Income Tax Withheld	Local Income Tax Withheld	Combined Federal/ State Code	Blank or CR/LF
544	545–662	663–722	723–734	735–746	747–748	749–750

(15) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-Q			
Field Position	***Field Title***	***Length***	***Description and Remarks***
544–546	*Blank*	*3*	*Enter blanks.*
547	*Trustee to Trustee Roll-over Indicator*	*1*	***Required**. Enter a "1" (one) if reporting a trustee to trustee roll-over; otherwise, enter blank.*
548	*Type of Tuition Payment*	*1*	***Required**. Enter the appropriate code from the table below to indicate the type of tuition payment; otherwise, leave blank.* ***Indicator** — **Usage*** *1 — Private Payment* *2 — State Payment*
549	*Designated Beneficiary*	*1*	***Required**. Enter a "1" (one) if the recipient is not the designated beneficiary; otherwise, enter a blank.*
550–662	*Blank*	*113*	*Enter blanks.*
663–722	*Special Data Entries*	*60*	*This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.*
723–748	*Blank*	*26*	*Enter blanks.*
749–750	*Blank*	*2*	*Enter blanks or carriage return/line feed (CR/LF) characters.*

Payee "B" Record — Record Layout Positions 544–750 for 1099-Q

Blank	*Trustee to Trustee Rollover Indicator*	*Type of Tuition Payment*	*Designated Beneficiary*	*Blank*	*Special Data Entries*	*Blank*	*Blank or CR/LF*
544–546	*547*	*548*	*549*	*550–662*	*663–722*	*723–748*	*749–750*

(16) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-R			
Field Position	**Field Title**	**Length**	**Description and Remarks**
544	Blank	1	Enter blank.
545–546	Distribution Code (For a detailed explanation of distribution codes, see the *2002 Instructions for Forms 1099-R and 5498.*) ***See chart at the end of this record layout for a diagram of valid combinations of Distribution Codes.***	2	**Required**. Enter at least one distribution code from the table below. More than one code may apply. If only one code is necessary, it must be entered in position 545. If two codes are necessary, and one of the codes is an alpha code (except code A), the alpha code must be entered in position 545 and the numeric code in position 546 (for example G4, J8, etc.). Distribution code A, when applicable, must be entered in position 546 with a numeric code in position 545 (for example 7A). When using Code P for an IRA distribution under section 408(d)(4) of the Internal Revenue Code, the filer may also enter Code 1, 2, or 4, if applicable. Only three numeric combinations are acceptable: Codes 8 and 1, 8 and 2, and 8 and 4 on one return. These three combinations can be used only if both codes apply to the distribution being reported. If more than one numeric code is applicable to different parts of a distribution, report two separate "B" Records. Distribution Codes E, F, H, N, R, and S cannot be used with any other codes. Distribution Code G may be used with Distribution Code 4 only if applicable.

Code	Category
1	*Early distribution, no known exception (in most cases, under age 59 1/2)
2	*Early distribution, exception applies (Under age 59 1/2)
3	*Disability
4	*Death
5	*Prohibited transaction
6	Section 1035 exchange (a tax-free exchange of life insurance, annuity, or endowment contracts)
7	*Normal distribution
8	*Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in *2002*
9	PS 58 costs (premiums paid by a trustee or custodian for current insurance protection)
A	May be eligible for 10-year tax option
D	*Excess contributions plus earnings/excess deferrals taxable in *2000*
E	Excess annual additions under section 415
F	Charitable gift annuity
G	Direct rollover to IRA
H	*Direct rollover to qualified plan or tax-sheltered annuity or a transfer from a conduit IRA to a qualified plan
J	Early distribution from a Roth IRA, no known exception (This code may be used with Code 5, 8, or P.)
L	Loans treated as deemed distributions under section 72(p)
M	Distribution from a Coverdell ESA
N	Recharacterized IRA contribution made for *2002*
P	*Excess contributions plus earnings/excess deferrals taxable in *2001*

(16) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-R (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
			R — Recharacterized IRA contribution made for *2001* (**See Note.**)
			S — *Early distribution from a SIMPLE IRA in first 2 years, no known exception
			T — Roth IRA distribution, exception applies (This code may be used with Code 5, 8, or P.)

***If reporting a traditional IRA, SEP, or SIMPLE distribution or a Roth conversion, use the IRA/SEP/SIMPLE Indicator of "1" (one) in position 548 of the Payee "B" Record.**

☛ **Note: The trustee of the first IRA must report the recharacterization as a distribution on Form 1099-R (and the original contribution and its character on Form 5498).**

Field Position	Field Title	Length	Description and Remarks
547	Taxable Amount Not Determined	1	Enter "1" (one) only if the taxable amount of the payment entered for Payment Amount Field 1 (Gross Distribution) of the "B" Record cannot be computed; otherwise, enter blank. (If Taxable Amount Not Determined Indicator is used, enter "0's" [zeros] in Payment Amount Field 2 of the Payee "B" Record.) Please make every effort to compute the taxable amount.
548	IRA/SEP/SIMPLE Indicator	1	Enter "1" (one) for a traditional IRA, SEP, or SIMPLE distribution or Roth conversion; otherwise, enter a blank. (**See Note.**) If the IRA/SEP/SIMPLE Indicator is used, enter the amount of the Roth conversion or distribution in Payment Amount Field A of the Payee "B" Record. **Do not use the indicator for a distribution from a Roth or Coverdell ESA or for an IRA recharacterization.**

☛ **Note: For Form 1099-R, generally, report the Roth conversion or total amount distributed from a traditional IRA, SEP, or SIMPLE in Payment Amount Field A (traditional IRA/SEP/SIMPLE distribution or Roth conversion), as well as Payment Amount Field 1 (Gross Distribution) of the "B" Record. Refer to the *2002 Instructions for Forms 1099-R and 5498* for exceptions (Box 2a instructions).**

Field Position	Field Title	Length	Description and Remarks
549	Total Distribution Indicator (**See Note.**)	1	Enter a "1" (one) only if the payment shown for Distribution Amount Code 1 is a total distribution that closed out the account; otherwise, enter a blank.

☛ **Note: A total distribution is one or more distributions within one tax year in which the entire balance of the account is distributed. Any distribution that does not meet this definition is not a total distribution.**

Field Position	Field Title	Length	Description and Remarks
550–551	Percentage of Total Distribution	2	Use this field when reporting a total distribution to more than one person, such as when a participant is deceased and a payer distributes to two or more beneficiaries. Therefore, if the percentage is 100, leave this field blank. If the percentage is a fraction, round off to the nearest whole number (for example, 10.4 percent will be 10 percent; 10.5 percent will be 11 percent). Enter the percentage received by the person whose TIN is included in positions 12–20 of the "B" Record. This field must be right-justified and unused positions must be zero-filled. If not applicable, enter blanks. Filers are not required to enter this information for any IRA distribution or for direct rollovers.
552–662	Blank	111	Enter blanks:

(16) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-R (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. The state/payer's state number, state distribution, name of locality, and/or local distribution can be entered in this field. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries field.
747–748	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 13, Table 1. For those payers or states not participating in this program, enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

FORM 1099-R DISTRIBUTION CODE CHART 2002

	blank	1	2	3	4	5	6	7	8	9	A	D	E	F	G	H	J	L	M	N	P	R	S	T
1	X								X			X						X			X			
2	X								X			X						X			X			
3	X																		X					
4	X								X		X	X			X			X	X		X			
5	X																X							X
6	X																							
7	X										X													
8	X	X	X		X												X		X					X
9	X																							
A	X				X			X																
D	X	X	X		X																			
E	X																							
F	X																							
G	X				X																			
H	X																							
J	X					X			X												X			
L	X	X	X		X																			
M	X			X	X				X												X			
N	X																							
P	X	X	X		X												X		X					X
R	X																							
S	X																							
T	X					X			X												X			

X – Denotes valid combinations

Payee "B" Record — Record Layout Positions 544–750 for Form 1099-R

Blank	Distribution Code	Taxable Amount Not Determined Indicator	IRA/SEP/SIMPLE Indicator	Total Distribution Indicator
544	545–546	547	548	549

Percentage of Total Distribution	Blank	Special Data Entries	State Income Tax Withheld	Local Income Tax Withheld	Combined Federal/ State Code	Blank or CR/LF
550–551	552–662	663–722	723–734	735–746	747–748	749–750

(17) Payee "B" Record — Record Layout Positions 544–750 for Form 1099-S

Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	Property or Services Indicator	1	**Required**. Enter "1" (one) if the transferor received or will receive property (other than cash and consideration treated as cash in computing gross proceeds) or services as part of the consideration for the property transferred. Otherwise, enter a blank.
548–555	Date of Closing	8	**Required**. Enter the closing date in the format YYYYMMDD (e.g., January 5, 2002, would be 20020105). **Do not enter hyphens or slashes.**
556–594	Address or Legal Description	39	**Required**. Enter the address of the property transferred (including city, state, and ZIP Code). If the address does not sufficiently identify the property, also enter a legal description, such as section, lot, and block. For timber royalties, enter "TIMBER." If fewer than 39 positions are required, left-justify information and fill unused positions with blanks.
595–662	Blank	68	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries Field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries Field.
747–748	Blank	2	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 1099-S

Blank	Property or Services Indicator	Date of Closing	Address or Legal Description	Blank	Special Data Entries
544–546	547	548–555	556–594	595–662	663–722

State Income Tax Withheld	Local Income Tax Withheld	Blank	Blank or CR/LF
723–734	735–746	747–748	749–750

(18) Payee "B" Record — Record Layout Positions 544–750 for Form 5498

Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	**IRA** Indicator (Individual Retirement Account)	1	**Required, if applicable**. Enter "1" (one) if reporting a rollover (Amount Code 2) or Fair Market Value (Amount Code 5) for an IRA. Otherwise, enter a blank.
548	**SEP** Indicator (Simplified Employee Pension)	1	**Required, if applicable**. Enter "1" (one) if reporting rollover (Amount Code 2) or Fair Market Value (Amount Code 5) for a SEP. Otherwise, enter a blank.
549	**SIMPLE Indicator** (Savings Incentive Match Plan for Employees)	1	**Required, if applicable**. Enter "1" (one) if reporting a rollover (Amount Code 2) or Fair Market Value (Amount Code 5) for a SIMPLE. Otherwise, enter a blank.
550	**Roth IRA** Indicator	1	**Required, if applicable**. Enter "1" (one) if reporting a rollover (Amount Code 2) or Fair Market Value (Amount Code 5) for a Roth IRA. Otherwise, enter a blank.
551	Blank	1	Enter blank.
552	***Coverdell ESA*** *Indicator*	1	***Required, if applicable****. Enter "1" (one) if reporting a rollover (Amount Code 2) or Fair Market Value (Amount Code 5) for a Coverdell ESA. Otherwise, enter a blank.*
553–662	Blank	110	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–746	Blank	24	Enter blanks.
747–748	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 13, Table 1. For those payers or states not participating in this program, enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 5498

Blank	IRA Indicator	SEP Indicator	SIMPLE Indicator	Roth IRA Indicator	Blank	*Coverdell ESA Indicator*
544–546	547	548	549	550	551	552

Blank	Special Data Entries	Blank	Combined Federal/ State Code	Blank or CR/LF
553–662	663–722	723–746	747–748	749–750

(19) Payee "B" Record — Record Layout Positions 544–750 for Form 5498-MSA

Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	Medicare+ Choice MSA Indicator	1	Enter "1" (one) for Medicare+Choice MSA.
548–662	Blank	115	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–748	Blank	26	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form 5498–MSA

Blank	Medicare+ Choice MSA Indicator	Blank	Special Data Entries	Blank	Blank or CR/LF
544–546	547	548–662	663–722	723–748	749–750

(20) Payee "B" Record — Record Layout Positions 544–750 for Form W-2G

Field Position	Field Title	Length	Description and Remarks
544–546	Blank	3	Enter blanks.
547	Type of Wager Code	1	**Required**. Enter the applicable type of wager code from the table below: Code — Category 1 — Horse race track (or off-track betting of a horse track nature) 2 — Dog race track (or off-track betting of a dog track nature) 3 — Jai-alai 4 — State-conducted lottery 5 — Keno 6 — Bingo 7 — Slot machines 8 — Any other type of gambling winnings

(20) Payee "B" Record — Record Layout Positions 544–750 for Form W-2G (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
548–555	Date Won	8	**Required**. Enter the date of the winning transaction in the format YYYYMMDD (e.g., January 5, 2002, would be 20020105). **Do not enter hyphens or slashes**. This is not the date the money was paid if paid after the date of the race (or game).
556–570	Transaction	15	**Required**. For state-conducted lotteries, enter the ticket or other identifying number. For keno, bingo, and slot machines, enter the ticket or card number (and color, if applicable), machine serial number, or any other information that will help identify the winning transaction. For all others, enter blanks.
571–575	Race	5	If applicable, enter the race (or game) relating to the winning ticket; otherwise, enter blanks.
576–580	Cashier	5	If applicable, enter the initials or number of the cashier making the winning payment; otherwise, enter blanks.
581–585	Window	5	If applicable, enter the window number or location of the person paying the winning payment; otherwise, enter blanks.
586–600	First ID	15	For other than state lotteries, enter the first identification number of the person receiving the winning payment; otherwise, enter blanks.
601–615	Second ID	15	For other than state lotteries, enter the second identification number of the person receiving the winnings; otherwise, enter blanks.
616–662	Blank	47	Enter blanks.
663–722	Special Data Entries	60	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks.
723–734	State Income Tax Withheld	12	State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries field.
735–746	Local Income Tax Withheld	12	Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right-justified and unused positions must be zero-filled. If not reporting local tax withheld, this field may be used as a continuation of the Special Data Entries field.
747–748	Blank	2	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Payee "B" Record — Record Layout Positions 544–750 for Form W-2G

Blank	Type of Wager Code	Date Won	Transaction	Race	Cashier	Window	First ID
544–546	547	548–555	556–570	571–575	576–580	581–585	586–600

Second ID	Blank	Special Data Entries	State Income Tax Withheld	Local Income Tax Withheld	Blank	Blank or CR/LF
601–615	616–662	663–722	723–734	735–746	747–748	749–750

Sec. 7. End of Payer "C" Record — General Field Descriptions and Record Layout

.01 The "C" Record consists of the total number of payees and the totals of the payment amount fields filed for each payer and/or particular type of return. The "C" Record must follow the last "B" Record for each type of return for each payer.

.02 For each "A" Record and group of "B" Records on the file, there must be a corresponding "C" Record.

.03 The End of Payer "C" Record is a fixed length of 750 positions. The control fields are each 18 positions in length.

Record Name: End of Payer "C" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter "C".
2–9	Number of Payees	8	**Required**. Enter the total number of "B" Records covered by the preceding "A" Record. Right-justify information and fill unused positions with zeros.
10–15	Blank	6	Enter blanks.
16–33	Control Total 1	18	**Required.** Accumulate totals of any payment amount fields in the "B" Records into the appropriate control total fields of the "C" Record. **Control totals must be right-justified and unused control total fields zero-filled.** All control total fields are 18 positions in length.
34–51	Control Total 2	18	
52–69	Control Total 3	18	
70–87	Control Total 4	18	
88–105	Control Total 5	18	
106–123	Control Total 6	18	
124–141	Control Total 7	18	
142–159	Control Total 8	18	
160–177	Control Total 9	18	
178–195	Control Total A	18	
196–213	Control Total B	18	
214–231	Control Total C	18	
232–499	Blank	268	Enter blanks.
500–507	*Record Sequence Number*	*8*	***Required**. Enter the number of the record as it appears within your file. The record sequence number for the "T" Record will always be "1" (one), since it is the first record on your file. Each record, thereafter, must be incremented by one in ascending numerical sequence, i.e. 2, 3, 4, etc. Right-justify numbers with leading zeroes in the field. For example, the "T" Record sequence number would appear as "00000001" in the field.*
508–748	Blank	241	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

End of Payer "C" Record — Record Layout

Record Type	Number of Payees	Blank	Control Total 1	Control Total 2	Control Total 3	Control Total 4	Control Total 5	Control Total 6
1	2–9	10–15	16–33	34–51	52–69	70–87	88–105	106–123

Control Total 7	Control Total 8	Control Total 9	Control Total A	Control Total B	Control Total C	Blank	*Record Sequence Number*
124–141	142–159	160–177	178–195	196–213	214–231	232–499	500–507

Blank	Blank or CR/LF
508–748	749–750

Sec. 8. State Totals "K" Record — General Field Descriptions and Record Layout

.01 The State Totals "K" Record is a summary for a given payer and a given state in the Combined Federal/State Filing Program, used **only** when state reporting approval has been granted.

.02 The "K" Record will contain the total number of payees and the total of the payment amount fields filed by a given payer for a given state. The "K" Record(s) must be written after the "C" Record for the related "A" Record. A file format diagram is located at the end of Part D.

.03 The "K" Record is a fixed length of 750 positions. The control total fields are each 18 positions in length.

.04 In developing the "K" Record, for example, if a payer used Amount Codes 1, 3, and 6 in the "A" Record, the totals from the "B" Records coded for this state would appear in Control Totals 1, 3, and 6 of the "K" Record.

.05 There must be a separate "K" Record for **each state** being reported.

.06 Refer to Part A, Sec. 13, for the requirements and conditions that **must** be met to file via this program.

State Totals "K" Record — Record Layout Forms 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, 1099-R, and 5498

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter "K".
2–9	Number of Payees	8	**Required**. Enter the total number of "B" Records being coded for this state. Right-justify information and fill unused positions with zeros.
10–15	Blank	6	Enter blanks.
16–33	Control Total 1	18	**Required.** Accumulate totals of any payment amount fields in the "B" Records for each state being reported into the appropriate control total fields of the appropriate "K" Record. **Control totals must be right-justified and unused control total fields zero-filled.** All control total fields are 18 positions in length.
34–51	Control Total 2	18	
52–69	Control Total 3	18	
70–87	Control Total 4	18	
88–105	Control Total 5	18	
106–123	Control Total 6	18	
124–141	Control Total 7	18	
142–159	Control Total 8	18	
160–177	Control Total 9	18	
178–195	Control Total A	18	
196–213	Control Total B	18	
214–231	Control Total C	18	
232–499	Blank	268	Enter blanks.
500–507	*Record Sequence Number*	*8*	**Required**. *Enter the number of the record as it appears within your file. The record sequence number for the "T" Record will always be "1" (one), since it is the first record on your file. Each record, thereafter, must be incremented by one in ascending numerical sequence, i.e. 2, 3, 4, etc. Right-justify numbers with leading zeroes in the field. For example, the "T" Record sequence number would appear as "00000001" in the field.*
508–706	Blank	199	Enter blanks.

State Totals "K" Record — Record Layout Forms 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, 1099-R, and 5498 (Continued)

Field Position	Field Title	Length	Description and Remarks
707–724	State Income Tax Withheld Total	18	State income tax withheld total is for the convenience of the filers. Aggregate totals of the state income tax withheld field in the Payee "B" Records; otherwise, enter blanks.
725–742	Local Income Tax Withheld Total	18	Local income tax withheld total is for the convenience of the filers. Aggregate totals of the local income tax withheld field in the Payee "B" Records; otherwise, enter blanks.
743–746	Blank	4	Enter blanks.
747–748	Combined Federal/State Code	2	**Required**. Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 13, Table 1.)
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

State Totals "K" Record — Record Layout Forms 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, 1099-R, and 5498

Record Type	Number of Payees	Blank	Control Total 1	Control Total 2	Control Total 3	Control Total 4	Control Total 5	Control Total 6
1	2–9	10–15	16–33	34–51	52–69	70–87	88–105	106–123

Control Total 7	Control Total 8	Control Total 9	Control Total A	Control Total B	Control Total C	Blank	*Record Sequence Number*	Blanks
124–141	142–159	160–177	178–195	196–213	214–231	232–499	500–507	508–706

State Income Tax Withheld Total	Local Income Tax Withheld Total	Blank	Combined Federal/ State Code	Blank or CR/LF
707–724	725–742	743–746	747–748	749–750

Sec. 9. End of Transmission "F" Record — General Field Descriptions and Record Layout

.01 The End of Transmission "F" Record is a summary of the number of payers in the entire file.
.02 The "F" Record is a fixed record length of 750 positions.
.03 This record must be written after the last "C" Record (or last "K" Record, when applicable) of the entire file.

Record Name: End of Transmission "F" Record

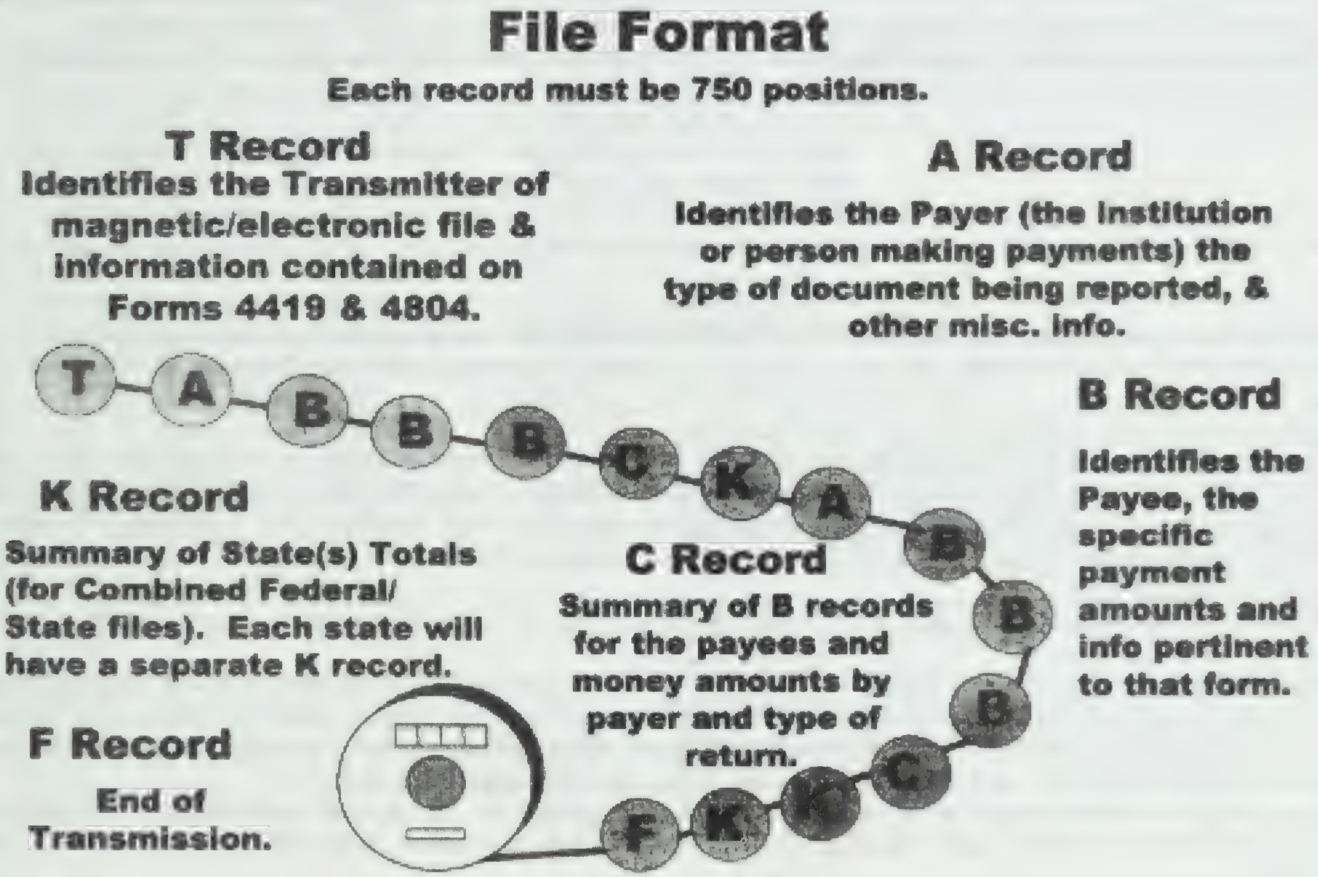
Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter "F".
2–9	Number of "A" Records	8	Enter the total number of Payer "A" Records in the entire file (right-justify and zero-fill) or enter all zeros.
10–30	Zero	21	Enter zeros.
31–49	Blank	19	Enter blanks.
50–57	*Total Number Payees*	8	*Enter the total number of Payee "B" Records reported in the file. Right-justify information and fill unused positions with zeros. If you have entered this total in the "T" Record, you may leave this field blank.*

Record Name: End of Transmission “F” Record (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
58–499	*Blank*	*442*	*Enter blanks.*
500–507	*Record Sequence Number*	*8*	***Required**. Enter the number of the record as it appears within your file. The record sequence number for the “T” Record will always be “1” (one), since it is the first record on your file. Each record, thereafter, must be incremented by one in ascending numerical sequence, i.e. 2, 3, 4, etc. Right-justify numbers with leading zeroes in the field. For example, the “T” Record sequence number would appear as “00000001” in the field.*
508–748	Blank	241	Enter blanks.
749–750	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

End of Transmission “F” Record — Record Layout

Record Type	Number of “A” Records	Zero	Blank	*Total Number of Payees*	Blank	*Record Sequence Number*	Blank	Blank or CR/LF
1	2–9	10–30	31–49	50–57	58–499	500–507	508–748	749–750

Sec. 10. File Layout Diagram



Part E. Extensions of Time and Waivers

Sec. 1. General — Extensions

.01 An extension of time to file may be requested for Forms 1098, 1099, 5498, 5498-MSA, W-2G, W-2 series, 8027 and 1042-S.

.02 Form 8809, Request for Extension of Time To File Information Returns, should be submitted to IRS/MCC at the address listed in .08 of this section. This form may be used to request an extension of time to file information returns submitted on paper, electronically, or magnetically to the IRS. Use a separate Form 8809 for each method of filing information returns you intend to use, i.e. electronically and/or magnetically.

.03 To be considered, an extension request must be postmarked or transmitted by the due date of the returns; otherwise, the request will be denied. (See Part A, Sec. 9, for due dates.) If requesting an extension of time to file several types of forms, use one Form 8809; however, the Form 8809 or file must be postmarked no later than the earliest due date. For example, if requesting an extension of time to file both Forms 1099-INT and 5498, submit Form 8809 on or before February 28, 2003. (**See Note.**)

☛ **Note: For Tax Year 2002, if you will be filing Forms 1098, 1099, or W-2G *electronically,* the Form 8809 is not required unless an extension is needed beyond March 31, 2003.**

.04 As soon as it is apparent that a 30-day extension of time to file is needed, an extension request should be submitted. It will take a minimum of 30 days for IRS/MCC to respond to an extension request. Generally, IRS/MCC does not begin processing extension requests until January. Extension requests received prior to January are input on a first come, first serve basis.

.05 Under certain circumstances, a request for an extension of time could be denied. When a denial letter is received, any additional or necessary information may be resubmitted within 20 days.

.06 Requesting an extension of time for multiple payers (50 or less) may be done by submitting Form 8809 and attaching a list of the payer names and associated TINs (EIN or SSN). **The listing must be attached to ensure an extension is recorded for all payers**. Form 8809 may be computer-generated or photocopied. Be sure that all the pertinent information is included.

.07 Requests for an extension of time to file for more than 50 payers are **required** to be submitted electronically or magnetically. IRS encourages requests for 10 to 50 payers to be filed electronically or magnetically. (See Sec. 3, for the file format.) The request may be filed electronically, on tape cartridges, 8mm, 4mm, Quarter-Inch Cartridges (QIC), or 3½–inch diskette.

.08 All requests for an extension of time filed on Form 8809 or magnetic media should be sent using the following address:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
240 Murall Drive
Kearneysville, WV 25430

☛ **Note: Due to the large volume of mail received by IRS/MCC and the time factor involved in processing the Form 8809, it is imperative that the attention line be present on all envelopes or packages containing Extension of Time (EOT) requests.**

.09 Requests for extensions of time to file postmarked by the United States Postal Service on or before the due date of the returns, and delivered by United States mail to the IRS/MCC after the due date, are treated as timely under the "timely mailing as timely filing" rule. A similar rule applies to designated private delivery services (PDSs). See Part A, Sec. 9, for more information on PDSs. For requests delivered by a designated PDS, but through a non-designated service, the actual date of receipt by IRS/MCC will be used as the filing date.

.10 Transmitters requesting an extension of time for multiple payers will receive one approval letter, accompanied by a list of payers covered under that approval.

.11 If an additional extension of time is needed, a second Form 8809 or file must be filed by the initial extended due date. Check line 7 on the form to indicate that an additional extension is being requested. A second 30-day extension will be approved only in cases of extreme hardship or catastrophic event. **If requesting a second 30-day extension of time, submit the information return files as soon as prepared. Do not wait for MCC's response to your second extension request.**

.12 If an extension request is approved, the approval letter should be kept on file. The approval letter or copy of the approval letter for an extension of time should **not** be sent to IRS/MCC with the magnetic media file or to the service center where the paper returns are filed.

.13 Request an extension for only one tax year.

.14 The extension request must be signed by the payer or a person who is duly authorized to sign a return, statement, or other document for the payer.

.15 Failure to properly complete and sign Form 8809 may cause delays in processing the request or result in a denial. Carefully read and follow the instructions on the back of the Form 8809.

.16 Form 8809 may be obtained by calling **1–800–TAX-FORM (1–800–829–3676)**. The form is also available on the **IRS Web Site at www.irs.gov**. A copy of Form 8809 is also provided in the back of Publication 1220.

Sec. 2. Specifications for Electronic Filing or Magnetic Media Extensions of Time

.01 The specifications in Sec. 3 include the required 200-byte record format for extensions of time to file requests submitted electronically or magnetically. Also included are the instructions for the information that is to be entered in the record. **Filers are advised to read this section in its entirety to ensure proper filing.**

.02 If a filer does not have an IRS/MCC assigned Transmitter Control Code (TCC), a Form 4419, Application for Filing Information Returns Electronically/Magnetically, **must** be submitted to obtain a TCC. This number **must** be used to submit an extension request electronically/magnetically. (See Part A, Sec. 6.)

.03 For extension requests filed on magnetic media, the transmitter must mail the completed, signed Form 8809, Request for Extension of Time To File Information Returns, in the same package as the corresponding media or fax it to 304–264–5602. For extension requests filed electronically, the transmitter must fax the Form 8809 the same day the transmission is made.

.04 Transmitters submitting an extension of time electronically or magnetically should not submit a list of payer names and TINs with the Form 8809 since this information is included on the electronic or magnetic file. However, Line 6 of the Form 8809 must be completed with the total number of records included on the electronic file or magnetic media.

.05 Do not submit Tax Year 2002 extensions of time to file requests on magnetic media before *January 1, 2003*, or electronically before *January 7, 2003*.

.06 Each piece of magnetic media **must** have an external media label containing the following information:

(a) Transmitter name

(b) Transmitter Control Code (TCC)

(c) Tax year

(d) The words "Extension of Time"

(e) Record count

.07 *Electronic filing, tape cartridge, 8mm, 4mm, QIC, and 3½-inch diskette specifications for extensions are the same as the specifications for filing of information returns. (See Part B or C for specific technical information.)*

Sec. 3. Record Layout — Extension of Time

.01 Positions 6 through 185 of the following record should contain information about the **payer** for whom the extension of time to file is being requested. Do not enter transmitter information in these fields. **Only one TCC may be present in a file.**

Record Layout for Extension of Time

Field Position	Field Title	Length	Description and Remarks
1–5	Transmitter Control Code	5	**Required**. Enter the five-digit Transmitter Control Code (TCC) issued by IRS. **Only one TCC per file is acceptable.**
6–14	Payer TIN	9	**Required**. Must be the valid nine-digit EIN/SSN assigned to the payer. **Do not enter blanks, hyphens, or alpha characters**. All zeros, ones, twos, etc., will have the effect of an incorrect TIN. For foreign entities that are not required to have a TIN, this field may be blank; however, the Foreign Entity Indicator, position 187, **must** be set to "X".
15–54	Payer Name	40	**Required**. Enter the name of the payer whose TIN appears in positions 6–14. Left-justify information and fill unused positions with blanks.
55–94	Second Payer Name	40	If additional space is needed, this field may be used to continue name line information (e.g., c/o First National Bank); otherwise, enter blanks.
95–134	Payer Address	40	**Required**. Enter the payer's address. Street address should include number, street, apartment, or suite number (or PO Box if mail is not delivered to a street address).
135–174	Payer City	40	**Required**. Enter payer city, town, or post office.

Record Layout for Extension of Time (Continued)			
Field Position	**Field Title**	**Length**	**Description and Remarks**
175–176	Payer State	2	**Required**. Enter the payer valid U.S. Postal Service state abbreviation. (Refer to Part A, Sec. 15.)
177–185	Payer ZIP Code	9	**Required**. Enter payer ZIP Code. If using a five-digit ZIP Code, left-justify information and fill unused positions with blanks.
186	Document Indicator **(See Note.)**	1	**Required**. Enter the appropriate code of the Document Indicator for which you are requesting an extension of time. **Code** — **Document** 1 — W-2 2 — 1098, 1098-E, 1098-T, 1099-A, 1099-B, 1099-C, 1099-DIV, 1099-G, 1099-INT, 1099-LTC, 1099-MISC, 1099-MSA, 1099-OID, 1099-PATR, 1099-Q, 1099-R, 1099-S, or W-2G 3 — 5498 4 — 1042–S 5 — REMIC Documents (1099–INT or 1099–OID) 6 — 5498–MSA

☛ **Note: Do not enter any other values in this field. Submit a separate record for each document. For example, if you are requesting an extension for Form 1099-INT and Form 5498 for the same payer, submit one record with "2" coded in this field and another record with "3" coded in this field. If you are requesting an extension for Form 1099-DIV and Form 1099-MISC for the same payer, submit one record with "2" coded in this field.**

187	Foreign Entity Indicator	1	Enter character "X" if the payer is a foreign entity.
188–198	Blank	11	Enter blanks.
199–200	Blank	2	Enter blanks or carriage return/line feed (CR/LF) characters.

Extension of Time Record Layout

Transmitter Control Code	Payer TIN	Payer Name	Second Payer Name	Payer Address	Payer City	Payer State
1–5	6–14	15–54	55–94	95–134	135–174	175–176

Payer ZIP Code	Document Indicator	Foreign Entity Indicator	Blank	Blank or CR/LF
177–185	186	187	188–198	199–200

Sec. 4. Extension of Time for Recipient Copies of Information Returns

.01 Request an **extension of time to furnish the statements to recipients** of Forms 1098, 1099, 5498, W-2G, W-2 series, and 1042-S by submitting a letter to IRS/MCC at the address listed in Part E, Sec. 1.08. The letter should contain the following information:

(a) Payer name
(b) TIN
(c) Address
(d) Type of return
(e) Specify that the extension request is to provide statements to recipients
(f) Reason for delay
(g) Signature of payer or duly authorized person

.02 Requests for an extension of time to furnish the statements to recipients for Forms 1098, 1099, 5498, W-2G, W-2 series, and 1042-S are not automatically approved; however, if approved, generally an extension will allow a maximum of 30 additional days from the due date to furnish the statements to the recipients. The request must be postmarked by the date on which the statements are due to the recipients.

.03 Generally, only the payer may sign the letter requesting the extension for recipient copies. A transmitter may sign if given power of attorney; however, a letter signed by the payer stating this fact must be attached to the extension request letter. A transmitter **must** submit a separate extension request letter for each payer. **Do not** submit a list of payers.

Sec. 5. Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media

.01 If a payer is required to file on magnetic media but fails to do so (or fails to file electronically in lieu of magnetic media filing) and does not have an approved waiver on record, the payer will be subject to a penalty of $50 per return in excess of 250. (For penalty information, refer to the Penalty Section of the *2002 General Instructions for Forms 1099, 1098, 5498, and W-2G.*)

.02 If payers are required to file original or corrected returns on magnetic media, but such filing would create a hardship, they may request a waiver from these filing requirements by submitting Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, to IRS/MCC. A Form 8508 can be obtained on the IRS Web Site at *www.irs.gov* or by calling toll-free 1–800–829–3676.

.03 Even though a payer may submit as many as 249 corrections on paper, IRS encourages electronic or magnetic filing of corrections. Once the 250 threshold has been met, filers are required to submit any returns of 250 or more electronically or magnetically. However, if a waiver for original documents is approved, any corrections for the same type of returns will be covered under this waiver.

.04 Generally, only the payer may sign the Form 8508. A transmitter may sign if given power of attorney; however, a letter signed by the payer stating this fact must be attached to the Form 8508.

.05 A transmitter must submit a separate Form 8508 for each payer. Do not submit a list of payers.

.06 All information requested on the Form 8508 must be provided to IRS for the request to be processed.

.07 The waiver, if approved, will provide exemption from the magnetic media filing requirement for the current tax year only. Payers may not apply for a waiver for more than one tax year at a time; application must be made each year a waiver is necessary.

.08 Form 8508 may be photocopied or computer-generated as long as it contains all the information requested on the original form.

.09 Filers are encouraged to submit Form 8508 to IRS/MCC at least 45 days before the due date of the returns. Generally, IRS/MCC does not process waiver requests until January. Waiver requests received prior to January are processed on a first come, first serve basis.

10. All requests for a waiver should be sent using the following address:

IRS-Martinsburg Computing Center
Information Reporting Program
240 Murall Drive
Kearneysville, WV 25430

.11 File Form 8508 for the W-2 series of forms with IRS/MCC not SSA.

.12 Waivers are evaluated on a case-by-case basis and are approved or denied based on criteria set forth in the regulations under Section 6011(e) of the Internal Revenue Code. The transmitter must allow a minimum of 30 days for IRS/MCC to respond to a waiver request.

.13 If a waiver request is approved, the transmitter should keep the approval letter on file. The transmitter should not send a copy of the approved waiver to the service center where the paper returns are filed.

.14 An approved waiver from filing information returns on magnetic media does not provide exemption from all filing. The payer must timely file information returns on Copy A of acceptable paper forms with the appropriate service center.

Part IV. Items of General Interest

New Revision of Publication 947, *Practice Before the IRS and Power of Attorney*

Announcement 2002–58

Publication 947, revised April 2002, is currently available from the Internal Revenue Service. It replaces the January 1999 revision.

This publication provides information on who can represent a taxpayer before the Internal Revenue Service and what forms or documents are used to authorize someone to represent a taxpayer.

You can get a copy of this publication by calling 1–800–829–3676. You can also write the IRS Forms Distribution Center nearest you. Check your income tax package for the address. The publication is also available on the IRS Internet web site at *www.irs.gov*.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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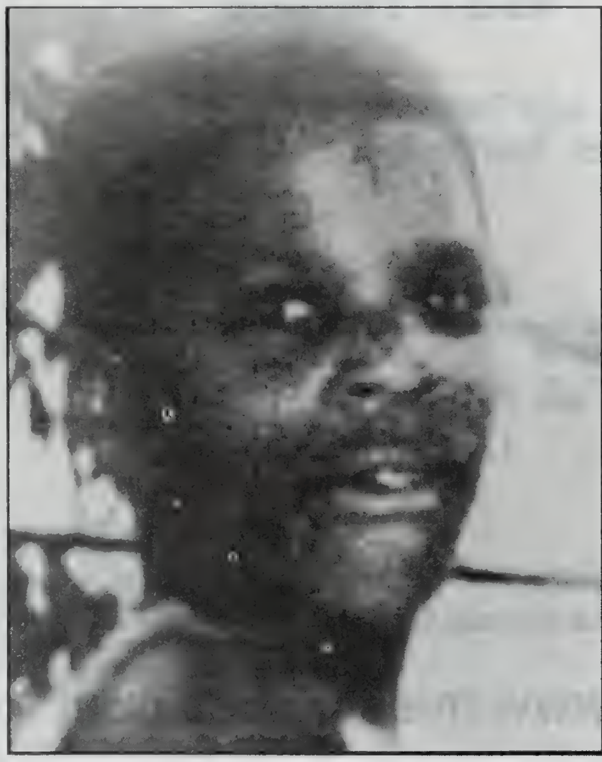

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